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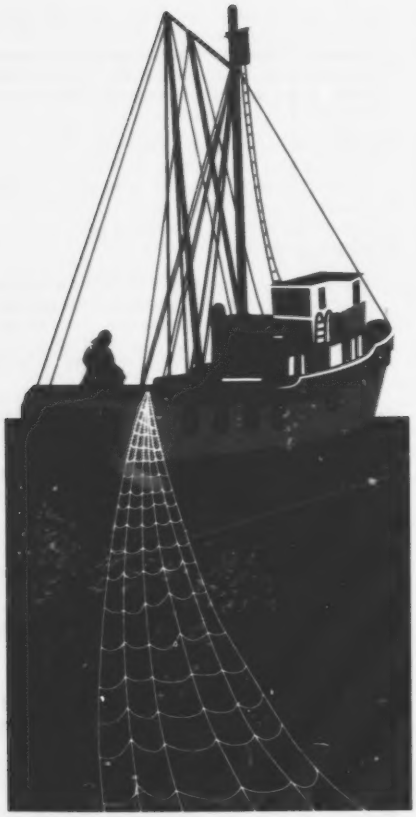
Tax Guide for Commercial Fishermen

For use in preparing
1990 Returns



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Contents

Introduction.....1
Important Changes for 1990.....1
Important Reminders.....2
Dates To Remember.....2
Chapter
1. Filing Requirements and Return Forms.....3
2. Importance of Good Records.....5
3. Business Assets.....5
4. Determining Your Income.....7
5. Business Expenses.....8
6. Depreciation.....12
7. Gains and Losses.....16
8. Casualty and Theft Losses.....19
9. Reporting Gains and Losses.... 21
10. Self-Employment Tax.....22
11. Employment Taxes.....24
12. Capital Construction Fund.....27
13. Excise Taxes.....27
14. The Examination and Appeals Process.....30
15. Sample Record System and Tax Forms.....31

List of Publications.....44
Index.....45

Introduction

This publication explains how the federal tax laws apply to the fishing industry. It is written for the individual who is a sole proprietor and who reports profit or loss from fishing on Schedule C (Form 1040). It does not cover the corporate or partnership form of business operation. If you have questions about corporations or partnerships, you should read Publication 541, *Tax Information on Partnerships;* Publication 542, *Tax Information on Corporations;* or Publication 589, *Tax Information on S Corporations.*

Use this publication as a guide to figure your taxes and to fill out your tax return. If you need more information on any subject, you should get the specific IRS publication that deals with that topic. Many of these free publications are referred to throughout this publication. Order them, along with any forms you may need, by calling our toll-free telephone number 1–800–TAX–FORM (829–3676) or by writing to the Forms Distribution Center for your area. Forms Distribution Center addresses and publication titles are on page 44.

Important Changes for 1990

The following list highlights a number of changes in the tax law and administrative changes for 1990. A second list of items under *Important Reminders* contains information that may be helpful to know in preparing your tax return for 1990.

Change of address. If you change your mailing address, you should use Form 8822, *Change of Address,* to notify IRS of your new address. Be sure to include your suite, room, or other unit number. If you are changing both your home and business addresses, complete two separate forms. However, individuals who are also household employers and file Form 942 can use one form. Send the form to the Internal Revenue Service Center for your old address.

Standard mileage rate. The standard mileage rate for 1990 is 26 cents a mile for all business miles. You are not subject to the 15,000 mile annual limit that applied in earlier years. See Chapter 5.

New maximum net earnings for self-employment tax. The maximum amount of net earnings subject to the self-employment tax for 1990 is $51,300. See Chapter 10.

New self-employment tax rate. The tax rate for self-employment tax is 15.3% for 1990. (For 1991, the tax rate remains at 15.3%.) The 2% credit for 1989 and prior years has been replaced by two deductions. See Chapter 10.

New wage maximum for social security taxes. The maximum amount of wages subject to social security taxes for 1990 is $51,300. See Chapter 11.

New social security tax rate. The tax rate for social security taxes is 7.65% in 1990 for both the employee and the employer. (For 1991, the tax rate remains at 7.65%.) See Chapter 11.

New $100,000 deposit rule. After 1990, undeposited social security and withheld income taxes that reach $100,000 or more in any eighth-monthly deposit period must be deposited by the second banking day. However, you are still required to make deposits within 3 banking days when undeposited taxes reach at least $3,000 at the end of an eighth-monthly deposit period. See Chapter 11.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% for 1990. (For 1991, the tax rate decreases to 6.0%.) See Chapter 11.

Medical insurance. If you are self-employed or if you own more than 2% of the outstanding stock of an S corporation, you can deduct up to 25% of the cost paid on your behalf for providing medical insurance for yourself and your family, if you meet certain requirements. Under prior law, this deduction was scheduled to expire for tax years beginning after December 31, 1989.

The expiration date for this deduction has been extended to tax years beginning before October 1, 1990. If your tax year begins in 1990, you can include only medical insurance payments made before October 1, 1990, that provide coverage for periods before that date. See Chapter 5.

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged. See Chapter 7.

New Form 8824. Beginning in 1990, if you have a like-kind exchange, you must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797. See Chapter 9.

Penalties. Beginning in 1990, the following penalties for late tax deposits and late information returns are based on the length of time a deposit or information return is late. The penalty for furnishing statements to payees, however, is not time-related.

- ***Late tax deposits.*** After 1989, the penalty for a late tax deposit is:
  a) 2% for the first 5 days late,
  b) 5% for the 6th through the 15th day late,
  c) 10% for more than 15 days late, and
  d) 15% if the deposit is not made within 10 days after the IRS issues the first notice demanding payment.
- ***Late information returns.*** After 1989, the penalty for filing a late information return applies if you do not file by the due date, if you do not include all required information, or if you report incorrect information. The penalty is:
  a) $15 for each return filed within 30 days after the due date, up to a maximum of $75,000,

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b) $30 for each return filed after the 30–day period but by August 1, up to a maximum of $150,000, and

c) $50 for each return filed after August 1, or never filed, up to a maximum of $250,000.

Small businesses pay the same penalty for a return, but the maximums are lowered to $25,000, $50,000, and $100,000. A small business is one with average annual gross receipts of $5 million or less for the last 3 years ending before the calendar year the return is due, or since the business began if shorter.

- ***Late payee statements.*** After 1989, a $50 penalty applies for each statement you do not furnish a payee by the required date up to a maximum of $100,000. The penalty also applies if you do not include all required information, or if you report incorrect information.

Important Reminders

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service of tax laws enacted by Congress, Treasury regulations, and court decisions. However, the information given does not cover every situation and is not intended to replace the law or change its meaning. This publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the Service.

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. See Chapter 11.

Form W–4 for 1991. Fishermen who have employees should make new Forms W–4 available to their employees who have income tax withheld, and encourage them to check their income tax withholding situation for 1991. Those employees who owed a large amount of tax or received a large refund for 1990 may want to file a new Form W–4. For more information, see Publication 937, *Business Reporting.*

Information returns (Form 1099 Series). If you make total payments of $600 or more during the year to another person, other than a corporation, in the course of your fishing business, you must file information returns to report these payments for the year. See Chapter 1.

Capital Construction Fund (CCF). You may be able to reduce your taxable income by the amount you deposit in a CCF. Deposits to the CCF do not reduce self-employment income. See Chapter 12.

Recapture of investment credit. Although generally the investment tax credit is no longer available, you may have to recapture credits taken in earlier years. Recapture is necessary when you dispose of or stop using business property before the end of its recapture period. For more information, see Form 4255, *Recapture of Investment Credit.*

Rounding off to whole dollars. You may round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 cents to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and only round off the total.

Business codes for fishermen. You must enter on line B of Schedule C (Form 1040) a code that identifies your principal business or professional activity. See the sample return in Chapter 15.

Taxpayer assistance. Publication 910, *Guide to Free Tax Services,* provides information on where to get help in preparing tax returns. It describes the year-round services available in resolving questions on bills, letters, and notices received from Service Centers, as well as questions on the status of tax refunds. This publication lists free taxpayer information publications, with brief descriptions of their content, along with a list of related tax forms and schedules that you may need to complete your returns. For information on how to get Publication 910, see *IRS Publications,* at the end of this publication.

Tele-Tax. The IRS has a telephone service called Tele-Tax. This service provides recorded tax information tapes on about 140 topics covering such areas as filing requirements, employment taxes, taxpayer identification numbers, and tax credits. Recorded tax information is available 24 hours a day, 7 days a week to taxpayers using push-button telephones and during regular working hours for those using dial telephones. The topics covered and telephone numbers for your area are listed in the Form 1040 instructions.

Unresolved tax problems. The IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you have been unable to resolve through normal channels, write to your local IRS District Director or call your local IRS office for Problem Resolution assistance.

The Problem Resolution Office will take responsibility for your problem and make sure that it receives proper attention. Although this office cannot change the tax law or technical decisions, it can frequently clear up misunderstandings that resulted from previous contacts.

Hearing impaired taxpayers who have access to TDD equipment may call 1–800–829–4059 to ask for help from Problem Resolution.

Reminders—Before you file your tax return, be sure to:

Use the address label. Transfer the address label from the tax return package you received in the mail to your tax return, and make any necessary corrections.

Attach all forms. Attach all forms and schedules in sequence number order. The sequence number is just below the year in the upper right corner of the schedule or form. Attach any other statements or attachments last, even if they relate to another form or schedule. Do not attach these other statements to the related form or schedule.

Fill out Schedule SE (Form 1040) if you had self-employment income of $400 or more.

List income, deductions, credits, and tax items on the correct lines.

Make sure you sign and date the tax return.

Pay by check. Attach a check for any tax you owe. If the check accompanies your Form 1040, write your social security number on the check. If the check accompanies Form 1120, Form 1120–A, or Form 1120S, write your employer identification number, the tax period, and the tax form number on the check. Also include the telephone number and area code where you can be reached during the day.

Use addressed envelope. Use the addressed envelope in your 1990 tax form instructions. If you do not have an addressed envelope, mail your return to the address listed for your area under *Where to File* in your 1990 tax form instructions.

Dates To Remember

You should take the action indicated on or before the date listed. Saturdays, Sundays, and legal holidays have been taken into account, but local banking holidays have not. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Due dates for monthly and eighth-monthly deposits of withheld income taxes and social security taxes are explained in detail in Publication 509, *Tax Calendars for 1991.*

During January

Employers. Give every employee a Form W–2 showing income and social security information for 1990 as soon as possible. The due date for giving Form W–2 to your employees is *January 31, 1991.* Copy A of Form W–2 must be filed by *February 28, 1991.*

January 15

Fishermen. You may elect to pay your 1990 estimated tax in full. You can then file your 1990 income tax return (Form 1040) by *April 15.* If you do not pay your estimated tax at this time, your 1990 return will be due *March 1.*

January 31

Social security (FICA) taxes and withheld income tax. File Form 941 for income tax withheld and social security taxes for the 4th quarter of 1990 and pay or deposit any taxes due. However, if you have already deposited the tax you owe in full and on time, you have until *February 11* to file the return.

Federal unemployment (FUTA) tax. File Form 940 for 1990. If your undeposited tax is $100 or less, you can either pay it with your return or deposit it. If it is more than $100, you must deposit it. However, if you have already deposited the tax you owe for the year in full and on time, you have until *February 11* to file the return.

Fishing boat operators. Give every crew member who is considered self-employed a Form 1099–MISC showing information on crew shares. See also *February 28.*

February 11

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 4th quarter of 1990. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, you should have filed the return by *January 31.*

Federal unemployment tax. File Form 940 for 1990. This due date applies only if you had deposited the tax for the year in full and on time. If not, you should have filed the return by *January 31.*

February 28

Fishing boat operators. File a Form 1099–MISC (Copy A) for each crew member considered self-employed. Form 1099–MISC is used to show the member's crew shares for 1990. Use Form 1096 to summarize and transmit the Forms 1099–MISC.

All employers. File Form W–3, *Transmittal of Income and Tax Statements,* along with Copy A of all the Forms W–2 you issued for 1990.

March 1

Fishermen. File your 1990 income tax return (Form 1040) and pay any tax due. However, you have until *April 15* if you paid your 1990 estimated tax by *January 15, 1991.*

April 15

Individual fishermen. File an income tax return (Form 1040) for 1990 and pay any tax due. See Chapter 1.

April 30

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 1st quarter of 1991. However, if you have already deposited the tax you owe for the quarter in full and on time, you have until *May 10* to file the return.

Federal unemployment tax. If you are liable for FUTA tax (see Chapter 11), deposit the tax owed through March. No deposit is necessary if the liability for the quarter does not exceed $100.

May 10

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 1st quarter of 1991. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, you should have filed the return by *April 30.*

July 31

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 2nd quarter of 1991. However, if you have already deposited the tax you owe for the quarter in full and on time, you have until *August 12* to file the return.

Federal unemployment tax. If you are liable for FUTA tax, deposit the tax owed through June. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment tax for the 1st quarter, does not exceed $100.

August 12

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 2nd quarter of 1991. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, you should have filed the return by *July 31.*

October 31

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 3rd quarter of 1991. However, if you have already deposited the tax you owe for the quarter in full and on time, you have until *November 12* to file the return.

Federal unemployment tax. If you are liable for FUTA tax, deposit the tax owed through September. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment tax for previous quarters, does not exceed $100.

November 12

Social security taxes and withheld income tax. File Form 941 (or 941E) for the 3rd quarter of 1991. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, you should have filed the return by *October 31.*

1. Filing Requirements and Return Forms

If you are a citizen or resident of the United States, single or married, and your gross income for the tax year is at least the amount shown in the category below that applies to you, you must file a 1990 federal income tax return even if no tax is due. This also applies to minor children. Gross income is discussed in Chapter 4.

Who must file

If filing status is:	A return is required if income is at least:
Single	
Under 65	$ 5,300
65 or older	6,100
Head of Household	
Under 65	$ 6,800
65 or older	7,600
Married Filing Jointly	
Both under 65	$ 9,550
One spouse 65 or older	10,200
Both 65 or older	10,850
Not living with spouse at end of year (or on date spouse died)	2,050
Married Filing Separately	
All—regardless of age	$ 2,050
Qualifying Widow(er)	
Under 65	$ 7,500
65 or older	8,150

Dependent's return. If you can claim someone as a dependent on your tax return (for example, your son or daughter), that person must generally file his or her own tax return if he or she:

1) Had only earned income, such as salary or wages, and the total is more than $3,250, or
2) Had only unearned income, such as interest and dividends, and the total is more than $500, or
3) Had both earned and unearned income, and the total is more than $500.

See the instructions that accompany your Form 1040 for more information on who must file a return for 1990.

Self-employed. If you are self-employed, you must file a return if you had net earnings of $400 or more from self-employment, even though you are not otherwise required to file an income tax return. See Chapter 10.

Earned income credit refund. You must also file a return to receive a refund from the earned income credit. See the instructions for Form 1040.

Identification number. You must show your taxpayer identification number (your social security or employer identification number) on all returns, statements, or documents you are required to file. For example, it must be shown on your federal income tax return, your estimated tax payment-voucher, and all information returns, such as Forms 1096 and 1099. A penalty of $5 may be levied for each failure to show the number.

Identification number to use. If you have to file an excise, alcohol, tobacco, firearms, or employment tax return, you should have an employer identification number and use that number on Schedule C for your fishing business. Otherwise, use your social security number. On your individual income tax return (Form 1040), computation of social security self-employment tax (Schedule SE), and estimated tax payment-voucher (Form 1040–ES), the identification number you should use is your social security number regardless of the number used on your business returns.

If you are married, show social security numbers for both you and your spouse on your Form 1040, whether you file jointly or separately. If you are filing a joint return, list the social security numbers in the same order that you show your first names. Also show both social security numbers on your Form 1040–ES if you make joint estimated tax payments.

Application for identification number. To apply for a social security number, use Form SS–5. If you are under 18 years of age, you must furnish evidence of age, identity, and U.S. citizenship with your Form SS–5. If you are 18 or older, you must appear in person with this evidence at a social security office.

To apply for an employer identification number, use Form SS–4. You can get these forms from any IRS or social security office.

Estimated Tax and Return Due Date

When you must pay estimated tax and file your return depends on whether you qualify as a fisherman. To qualify as a fisherman you must receive at least two-thirds of your total gross income from fishing in the current or prior year.

Gross Income

The amount of your gross income is used to determine if you must file a return. It is also used to determine if you qualify as a fisherman. To see if you qualify as a fisherman, figure the amount of your total gross income and then determine what percentage of this total comes from fishing.

Gross income is all income you receive in the form of money, property, and services that is not exempt from tax. It is the total income you receive before allowable deductions. For a business, gross income is total receipts minus cost of goods sold.

Joint return. On a joint return, you must add your spouse's gross income to your own gross income to determine if at least two-thirds of the total is from fishing.

For more information about figuring gross income, see Publication 505, *Tax Withholding and Estimated Tax.*

Gross Fishing Income

Gross income from fishing includes amounts you receive from the catching, taking, harvesting, cultivating, or farming of any kind of fish, shellfish (for example, clams and mussels), crustacea (for example, lobsters, crabs, and shrimp), sponges, seaweeds, or other aquatic forms of animal and vegetable life.

You receive gross income from fishing if you conduct your fishing business for a profit. Your gross fishing income also includes your share of a partnership's or S corporation's gross income from fishing.

You receive gross income from fishing if you are an officer or crew member of a boat that normally consists of less than 10 individuals and you do not receive any cash pay other than:

1) A share of the boat's catch, and
2) Your share depends on the amount of the catch.

Your share can be from the catch of more than one boat involved in a fishing operation, provided the crew of each boat in the operation normally consists of less than 10 individuals. For more information, see *Certain Crew Members Considered Self-Employed*, in Chapter 11.

If you are an officer or member of a crew and meet these qualifications, you are treated as self-employed and must pay estimated income and social security taxes and report your income on Schedule C (Form 1040). Your fishing services can include those ordinarily related to fishing, such as shore service that includes cleaning, icing, and packing fish.

If, as an officer or crew member, you do not meet these qualifications, you are an employee and receive wages subject to income tax and social security tax withholding by your employer. It does not matter whether your wages are dependent upon the catch of a boat. You do not qualify as a fisherman because your income is from wages for the performance of services and not from the trade or business of fishing.

Qualified Fishermen Due Dates

If you received at least two-thirds of your total gross income for 1989 from fishing, or you received at least two-thirds of your 1990 total gross income from fishing, you have only one payment due date for estimated tax—January 15, 1991.

Therefore, for your 1990 tax, you may either:

1) Pay all your estimated tax by January 15, 1991, and file your Form 1040 by April 15, 1991, or
2) File your Form 1040 by March 1, 1991, and pay all the tax that is due. You will not have a penalty for not paying estimated tax.

Penalties. If you do not pay all your required estimated tax by January 15, 1991 and you do not file your return or pay the tax by March 1, 1990, use Form 2210F, *Underpayment of Estimated Tax by Farmers and Fishermen*, to find out if you owe a penalty. If you owe a penalty but do not file Form 2210F and pay the penalty with your return, you will get a penalty notice from the IRS. You should pay the penalty as instructed by the notice.

Occasionally, you may get a penalty notice even though you filed your return on time and met the gross income test. If you receive a penalty notice for underpaying estimated tax that you think is in error, write to the address on the notice and explain why you think the notice is in error. Include a computation showing that you meet the gross income test. Do not ignore a penalty notice even if you think it is in error.

Fiscal years. If you qualify as a fisherman but your tax year does not start on January 1, you may file your return and pay the tax on or before the first day of the 3rd month after the close of your tax year. Or pay your required estimated tax within 15 days after the end of your tax year. Then file your return and pay any balance due on or before the 15th day of the 4th month after the end of your tax year.

Automatic extension of time to file Form 1040. If you do not choose to file your return on March 1, 1991, the due date for your 1990 return will be April 15, 1991. However, you can get an automatic 4-month extension of time to file your return. Your Form 1040 would then be due by August 15, 1991. To get this extension, file Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, by April 15, 1991.

This extension does ***not*** extend the March 1 filing date for fishermen who did not make an estimated tax payment and want to avoid an estimated tax penalty. Therefore, if you did not make an estimated tax payment by January 15 and you file your tax return after March 1, you will be subject to a penalty for underpaying your estimated tax even if you requested the automatic extension to file your return.

You must make a tentative tax estimate for the year for which you file Form 4868. Full payment of any tax due must be made with the application for the extension. If your Form 4868 shows no tax due but you have information at the time that you will have taxable income and owe tax, then your Form 4868 is invalid. If the total tentative tax paid is less than the final tax shown on your Form 1040, interest from the original due date will apply on the amount of the difference.

The late payment penalty of one-half of 1% a month up to a maximum of 25% also will apply unless there is reasonable cause for the delay. Reasonable cause will be presumed if the amount you owe on Form 1040 is no more than 10% of the total tax for the year and this amount is paid with Form 1040. For more information, see the instructions to Form 4868.

Nonqualified Fishermen Due Dates

If you did not qualify as a fisherman in 1990 because less than two-thirds of your total gross income was from fishing and you do not expect to qualify in 1991, you must make quarterly estimated tax payments on April 15, June 17, and September 16, 1991, and on January 15, 1992. You must file your income tax return by April 15, 1992. The exception for making estimated tax payments and the March 1 filing date do not apply.

Other Filing Information

If the last day for filing your return or making a payment falls on a Saturday, Sunday, or legal holiday, your return or payment will be on time if it is filed or made on the next day that is not a Saturday, Sunday, or legal holiday.

Where to file. File your returns with the Internal Revenue Service Center serving the place where you live. Use the envelopes mailed to you, or see a list of Service Center addresses on the instructions for the forms.

Information Returns

If you make payments during the calendar year to another person, other than a corporation, in the course of your fishing business, you must file information returns to report these payments for the calendar year. Form 1099–MISC is an information return used to report the amount of crew shares received by each crew member considered self-employed. Payments of $600 or more made for rents, commissions, fees, prizes, awards, and other payments and compensation including payments to subcontractors and payment for services provided to you by non-employees also are reported on Form 1099–MISC. Payments of $10 or more for royalties are reported on Form 1099–MISC.

Payments for merchandise, freight and similar charges, and for rental payments to real estate agents need not be reported. Payments for compensation to employees are reported on Form W–2, not on Form 1099–MISC.

Preparation of returns. You must prepare separate copies of Form 1099–MISC for each person. Copy A of the form must be filed with the IRS. A statement showing the information reported on Copy A of Form 1099–MISC must be furnished to each crew member considered self-employed, and to each other person to whom you made a payment that must be reported, by January 31 following the end of the calendar year. Copy B of Form 1099–MISC may be used for this purpose. There are ***penalties*** of $50 for each failure to file information returns and for each failure to furnish statements.

Because these forms are read by machine, you must type, or machine print, the entries using a black ribbon or ink. Handwritten forms are ***not*** acceptable. You must enter the city, state, and zip code on the same line. Make your entries in the middle of the blocks, separated from the preprinted lines and words on the form. Use clear, sharp, legible type or machine print. Enter amounts without dollar signs or commas. Use only a decimal point to separate dollars from cents. Do not fold or staple the forms.

Filing the returns. The various 1099 forms must be filed, along with the summary sheet Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, with the IRS at the address shown in the Form 1096 instructions on or before February 28 following the end of the calendar year. For more details about information returns, see Publication 937, *Business Reporting*.

Return Forms

The following forms are those most often used by fishermen. When filing your income tax return, arrange your forms and schedules in the correct order using the sequence numbers located in the upper right corner of the form under the year. Put all other statements or attachments last, even if they relate to another form or schedule. Do not attach these other statements to the related form or schedule.

Form 1040. You must list your taxable income from all sources on Form 1040, including your profit or loss from fishing operations as determined on Schedule C (Form 1040). You also figure your tax on this form.

Schedule C (Form 1040). This schedule is used by business people, including fishermen, filing on either the cash or the accrual method. List all your business income and deductions and determine your net profit or loss on Schedule C.

Schedule SE (Form 1040). This schedule is used to figure your social security self-employment tax.

Other schedules for Form 1040. Use Schedule A to list nonbusiness itemized deductions and Schedule B to report interest and dividend income. Use Schedule D to report gains and losses from sales of capital assets. Use Schedule E to report income or loss from rents, royalties, partnerships, estates, trusts, and S corporations.

Form 8822. Form 8822, *Change of Address*, should be used to notify IRS of a change in your mailing address. Be sure to include your suite, room or other unit number. If you are changing both your home and business addresses, complete two separate forms. However, individuals who are also household employers and file Form 942 can use one form. Send the form to the Internal Revenue Service Center for your old address.

Form 1099–MISC. Form 1099–MISC, *Statement for Recipients of Miscellaneous Income*, is an information return used to report the amount of crew shares received by each crew member considered self-employed, as discussed in Chapter 11. It is also used to report certain other payments you make during the year in the course of your business. See *Information Returns*, earlier. Form 1099–MISC is illustrated in Chapter 15.

This 1099 form is the one used most often by fishermen. However, there are other forms in the 1099 series. See Publication 937 for more details.

Form 1096. Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, is used to summarize and transmit to the IRS the various 1099 forms.

Form 4562. Form 4562, *Depreciation and Amortization*, is used to explain the deductions for depreciation and amortization on your tax return.

Form 4797. Form 4797, *Sales of Business Property*, is used to report gains and losses from the sale or exchange of business property and from

certain involuntary conversions. For example, gain or loss on the sale of your fishing boat is reported on Form 4797.

Form 2210F. Form 2210F, *Underpayment of Estimated Tax by Farmers and Fishermen,* is used by fishermen to figure any underpayment of estimated tax and the underpayment penalty.

Form 941. Form 941, *Employer's Quarterly Federal Tax Return,* must be filed quarterly by you if you have to withhold income tax from wages of your employees or if you are liable for social security tax. The returns and tax payments are due on or before the last day of the first month following the end of the calendar quarter. If you made timely deposits in full payment of taxes due, you may file your return as late as the 10th day of the 2nd month following the quarter.

Form W–2. Form W–2, *Wage and Tax Statement,* must be prepared for each employee from whose wages income tax has been withheld or would have been withheld if the employee had claimed no more than one withholding exemption, or to whom you paid wages subject to social security tax. The Form W–2 must show the total wages and other compensation paid, whether or not they are subject to withholding, and the amounts deducted for income tax and social security tax. In addition, in a trade or business, the W–2 must show the value of any payment for services that was not made in cash.

Send Copy A of each Form W–2 to the Office of the Social Security Administration with a completed Form W–3, *Transmittal of Income and Tax Statements,* on or before the last day of February. The correct mailing address for your area's Social Security Administration office may be found in the instructions for Form W–3. Copies B and C of Form W–2 must be given to the employee.

2. Importance of Good Records

If you have a business, you must keep records to correctly figure your taxes. Your records must be permanent, accurate, complete, and must clearly establish your income, deductions, credits, and employee information. The law does not require you to keep your records in any particular way. You may choose any system suited to your business that will clearly show your income.

Travel expenses. You are required to support your expenses for travel in connection with your business, including local travel, gifts, entertainment, and the business use of certain ***listed property,*** with adequate records or sufficient evidence to prove your own statements. ***Listed property*** includes all passenger automobiles, entertainment, amusement or recreation type property, and computer equipment. For more information on listed property, see Publication 534, *Depreciation.* Adequate records include account books, diaries, trip sheets, or similar items.

Records that are written at or near the time you incur the expenses are generally considered as adequate evidence. Oral statements or written records reconstructed much later cannot be relied on to support your expenses.

See Publication 463, *Travel, Entertainment, and Gift Expenses,* Publication 534, *Depreciation,* and Publication 917, *Business Use of a Car,* for more information.

Effective Records

Good records are needed for efficient management, applying for credit, and to support all items of income and expense reported on your tax return. The following suggestions are provided to help you maintain good records and show you some ways in which they may help.

Identify the source of income. The money or property you receive can come from many sources. Your records should identify the source of your income so you can show if an income item is taxable or nontaxable.

Maintain a record of deductible expenses. You may forget your deductible expenses when you prepare your tax return unless you record them when they occur. You should also retain the invoice, paid receipt, or canceled check that supports the item of expense in a safe, well-organized file

Figure depreciation deduction. You should note in a permanent record all business assets you can depreciate. Depreciation is the name given to recovering on your tax return the cost of your business property through periodic tax deductions. Without a record of the cost and other information on your business assets, you cannot figure your depreciation deductions. If you sell your assets, make capital improvements to them, or they become fully depreciated, only a permanent record along with invoices or receipts will show how much of their cost you have not recovered. For more information, see Chapter 6.

Figure your earnings for self-employment tax purposes. The self-employment tax is part of the system for providing social security coverage for people who work for themselves. Your social security benefits when you retire or become disabled, or the benefit payments to your family in case of your death, depend on how much you contributed to your social security account based on your net earnings. Your records should show how much of your earnings are subject to self-employment tax.

Support items reported on your examined tax return. If your income tax return is examined by the Internal Revenue Service (IRS), you may be asked to explain and support the items reported. Adequate and complete records should be supported by sales slips, invoices, receipts, canceled checks, and other documents. These documents explain and support the entries on your tax return.

Checkbook. Your business checkbook is the basic source for keeping a record of your business expenses. It is recommended that all daily receipts be recorded in your checkbook.

You should use a checkbook that provides enough space to enter sufficient information to determine later what receipts of money represent income to be reported on your tax return and what receipts represent transfers of personal funds, nontaxable reimbursements, or loans deposited.

Deposits. You should deposit all business receipts in a business bank account and set up a petty cash fund for small expenses. All business expenses paid by cash should be supported by cash receipts, invoices marked paid, or other documents that clearly show the expenses incurred were for business purposes.

Pay by check. You should pay all business expenses by check. Do not write business checks payable to cash or to yourself unless they are drawn for personal reasons. If you must write a check payable to cash or to yourself in order to pay a business expense by cash, include the receipt for the payment in your records. If you cannot get a receipt for a cash payment, you should record an adequate explanation in your records at the time of payment.

Recordkeeping. You must keep the books and records of your business available at all times for inspection by the IRS. Your records must be kept as long as they may be needed in the administration of any Internal Revenue law.

Retain records. Keep your records that support items of income or expenses reported on your tax return until the period of limitations for that return runs out. Usually this is the later of:

1) 3 years after the date your return is due or filed, or
2) 2 years after the tax is paid.

Your permanent books must show not only your gross receipts but also your deductions and credits. In addition, you must keep other records and data that you may need to support the entries in your records and tax or information returns. Work sheets, logs, diaries, paid bills, canceled checks, etc., that support entries in your books should be maintained in a safe, well-organized file.

If you are an employer, you must keep all your employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later. This includes copies of W–4, *Employee's Withholding Allowance Certificate,* undelivered employee copies of Form W–2, *Wage and Tax Statement,* and all payroll records. For more detailed information on employment tax records, see *Recordkeeping* in Publication 937, *Business Reporting.*

Keep records that support your cost basis in property for as long as they are needed to figure your correct cost basis of the original or replacement property (including capital improvements).

Keep copies of your tax returns. They will help you in preparing future tax returns and in making computations if you later file a claim for refund. They may also be helpful to the executor or administrator of your estate, or to the IRS if your original return is not available.

Illustrated records. For an illustration of a recordkeeping system, see Chapter 15, *Sample Record System and Tax Forms.*

3. Business Assets

An individual engaged in a business activity usually has property that is used in the business. This property contributes directly or indirectly toward earning the income of the business. Property used in a business is a business asset.

A business asset may be tangible property, such as a fishing vessel or fishing gear, or it may be intangible property such as a franchise right. The amount paid for a business asset is usually a capital expenditure.

You may get business assets in several ways. These include, but are not limited to:

1) Purchase for cash, or for a cash down payment plus your note for the rest of the purchase price,
2) Purchase as described in (1) except that you also trade in a used asset,
3) Inheritance,
4) Gift,
5) Conversion of property held for personal use into a business asset, and
6) Exchange of other assets.

Basis is a way of measuring your investment in property for tax purposes. The basis of property you buy is usually its cost to you. However, if you get the property in some other way, such as by gift or inheritance, you normally must use a basis other than cost. You must know the basis of the property to figure your depreciation on it and your gain or loss on its sale or other disposition.

While you own the property, various events may take place that change your original basis in the property. These events increase or decrease the

original basis. The result is called "adjusted basis."

To figure depreciation, use "unadjusted basis." For information on unadjusted basis and depreciation, see Chapter 6.

Cost Basis

The basis of property you buy is usually its cost. The cost usually is the amount you pay for it in cash, other property, or services. Your cost includes amounts you pay for sales tax, freight, installation, and testing.

Settlement fees or closing costs. Legal and recording fees are some of the settlement fees or closing costs included in the basis of property.

Assumption of a mortgage. If you buy property and become liable for an existing mortgage on the property, your basis is the amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a fishing vessel for $20,000 cash, and assume a mortgage of $80,000 on it, your basis is $100,000.

Constructing assets. If you construct real or tangible personal property for use in your business, you must capitalize (add to the basis) direct costs, such as labor and materials, and an allocable portion of most indirect costs that benefit the property. Indirect costs that benefit property include items such as depreciation, taxes, interest, and general administrative costs. If property is produced (constructed, built, installed, etc.) for you under a contract, it is treated as produced by you to the extent that you make payments or otherwise incur costs in connection with the property. For more information see *Business Assets* in Publication 551, *Basis of Assets.*

Adjusted Basis

Before you can figure any gain or loss on a sale, exchange, or other disposition of property, or figure allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to basis. The basis of any property is increased by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property. One of the items added to the basis of property is legal fees, such as the cost of defending and perfecting title.

If you make additions or improvements to business property, you must keep separate accounts for these and depreciate the basis of each according to the depreciation rules in effect when the addition or improvement was placed in service. For more information, see Chapter 6.

Decreases to basis. You must decrease the basis of your property by any items that represent a return of capital. These include the section 179 deduction, recognized losses on involuntary exchanges, casualty losses, and deductions previously allowed (or allowable) for amortization, depreciation, obsolescence, and depletion.

Section 179 deduction. If you elect to take the section 179 deduction for any part of the cost of property, you must decrease the basis of the property by the amount of the section 179 deduction. For more information, see Chapter 6.

Casualties and thefts. If you have a casualty or theft loss, you must decrease the basis of your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis for amounts you spend after a casualty to restore the damaged property. For more information, see Chapter 8.

Depreciation. You must decrease the basis of your property by the amount of depreciation you could have deducted for the property on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis by the amount you should have deducted plus that part of the excess that resulted in a decrease in your tax for any year. If you took less depreciation than you could have, you must decrease your basis by the amount you could have deducted. If you did not deduct any depreciation, figure the amount of depreciation you could have deducted as explained in Chapter 6.

Adjusted basis example. In 1986, you paid $40,000 for a used fishing boat. You also paid commissions of $2,000 and transportation charges of $1,600 for a total cost of $43,600. Immediately, you spent $14,200 to make the boat seaworthy. In 1989, you had a casualty loss of $2,000 to the boat from a fire that was not covered by insurance, and this loss was claimed as a deduction. You spent $2,500 to repair the fire damage. You were allowed depreciation of $45,872 for the years 1986 through 1989. The adjusted basis of the boat as of January 1, 1990, is figured as follows:

Original cost, including fees and transportation		$43,600
Adjustments to basis:		
Add:		
Improvements		14,200
Repair of fire damage		2,500
		$60,300
Subtract:		
Depreciation	$45,872	
Casualty loss	2,000	47,872
Adjusted basis January 1, 1990		$12,428

For more information about basis, see Publication 551.

Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value of the property, or the adjusted basis of certain property may be important.

Fair market value (FMV). The fair market value is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having a reasonable knowledge of all necessary facts.

Property Received for Services

If you receive property for services, you must include its FMV in income. The amount you include in income becomes your basis.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. Property becomes substantially vested when you can transfer it or it is not subject to a substantial risk of forfeiture. For more information, see the discussion on *Restricted Property Received for Services,* in Publication 525, *Taxable and Nontaxable Income.*

Taxable Exchange

A taxable exchange is one in which the gain is taxable or the loss is deductible. If you received property in exchange for other property in a taxable exchange, the basis of the property you received is usually its FMV at the time of the exchange.

Involuntary Exchange

If you acquire property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, the basis of the replacement property you acquire may be figured using the basis of the property exchanged.

Similar property received. If you receive property that is similar or related in service or use to the property exchanged, the basis of the new property is the same as the basis of the old property, on the date of the exchange, with the following adjustments:

1) Decreased by—
   a) Any loss recognized on the exchange, and
   b) Any money received that was not spent on similar property.
2) Increased by—
   a) Any gain recognized on the exchange, and
   b) Any cost of acquiring replacement property.

Unlike property received. If you receive money or other property not similar or related in service or use to the old property and you buy new property that is similar or related in service or use to the old property, the basis of the new property is its cost, decreased by the amount of gain not recognized on the exchange. See *Replacement property* in Chapter 8.

Nontaxable Exchange

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged. This rule applies to exchanges of property used in a trade or business or held for investment for property of a like kind.

Example. If you exchange real estate held for investment that has an adjusted basis of $50,000 and a FMV of $80,000 for other real estate held for investment that has a fair market value of $80,000, the basis of the new property is $50,000, the same basis as the old property.

Property plus cash. If you trade property in a nontaxable exchange and pay an additional amount, the basis of the property you receive is the same as the basis of the property you exchanged increased by the additional amount you paid.

Example. If you trade in a truck that has an adjusted basis of $3,000 for another truck that has a FMV of $7,500 and also pay $4,000 cash for the new truck, the basis of the new truck is $7,000 (the $3,000 basis of the old truck plus the $4,000 cash paid).

Related parties. There are special rules for exchanges of like-kind property between related persons. See *Special rules for related persons* under *Nontaxable Exchanges* in Publication 551, *Basis of assets.*

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the old property:

1) Decreased by—
   a) Any money received, and
   b) Any loss recognized on the exchange.
2) Increased by—
   a) Any additional costs incurred, and
   b) Any gain recognized on the exchange.

The assumption of your liabilities (including a nonrecourse obligation) by the other party to the transaction is treated as money transferred to you in the exchange.

The basis must be allocated among the properties, other than money, that you received in the exchange. In making this allocation, the basis of the unlike property is its fair market value on the date of the exchange. The remainder is allocated to the basis of the like property.

Example 1. If you exchange a truck that has an adjusted basis of $6,000 for a new, smaller truck that has a FMV of $5,200, and you receive $1,000 in cash, you have a recognized gain of $200 ($6,200 minus $6,000) and your basis in the new truck is figured as follows:

Adjusted basis of old truck	$6,000
Minus: Cash you received	1,000
	$5,000
Plus: Gain recognized	200
Basis of new truck	$5,200

Example 2. You had an adjusted basis of $15,000 in real estate you held for investment. You exchange it for $1,000 cash, other real estate to be held for investment with a FMV of $12,500, and a pleasure boat with a fair market value of $3,000. You have a gain of $1,500 recognized on the exchange. The basis of the properties you received is:

Adjusted basis of real estate transferred	$15,000
Cash received	1,000
	$14,000
Plus: Gain recognized	1,500
Total basis of properties received	$15,500

You must allocate the total basis of $15,500 between the boat and the real estate. The basis of the boat is its FMV, $3,000, and the basis of the real estate is the remainder, $12,500.

Trade-in or sale and purchase. You cannot increase the basis for depreciation of property by selling your old property outright to a dealer and then buying the new property from the same dealer, if the sale and purchase are actually a single transaction. If the sale to the dealer of your old property and your purchase from that dealer of the new property are dependent on each other, you are considered to have traded in your old property. The transaction is treated as an exchange no matter how it is carried out.

Exchange—loss not recognized. If you have an exchange that results in an unrecognized loss, the basis of the new property is the same as the basis of the old property, decreased by any money received. Allocate this basis among the properties, other than money, received in the exchange. In making this allocation, the basis of unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example. You exchanged a fishing boat used in your business that has an adjusted basis of $18,000 for a smaller fishing boat to be used in your business that has a FMV of $14,000, a truck for personal use that has a FMV of $2,500, and $500 cash. The loss of $1,000 ($17,000 minus $18,000) is not recognized on the exchange. The basis of the properties you received is:

Adjusted basis of your old boat	$18,000
Minus: Cash you received	500
Total basis of the properties you received	$17,500

Of the total basis of $17,500, $2,500 is for the truck you received and the remaining $15,000 is the basis of your new boat.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, the amount of the gift tax paid on it, and the date it was given to you.

FMV less than donor's adjusted basis. If the FMV of the property was less than the donor's adjusted basis, your basis for depreciation, depletion, and amortization, and for gain on its sale or other disposition is the same as the donor's adjusted basis. Your basis for loss on its sale or other disposition is its fair market value at the time of the gift.

FMV more than donor's adjusted basis. If the FMV of the property was equal to or greater than the donor's adjusted basis, your basis for depreciation, depletion, and amortization, and for gain or loss on its sale or other disposition, is the donor's adjusted basis at the time you received the gift. Your basis is increased by all or part of the gift tax paid, depending on the date of the gift.

Gift received before 1977. If you received a gift before 1977, your basis in the gift (the donor's adjusted basis) is increased by the total gift tax paid on it, but not above the FMV of the gift when it was given to you.

Example 1. You were given a fishing boat in 1976. At that time it had a FMV of $21,000 and the donor's adjusted basis was $20,000. The donor paid a gift tax of $500. Your basis for gain or loss and for depreciation is $20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. If, in Example 1, the gift tax paid had been $1,500, your basis would be $21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the boat at the time you received the gift.

Gift received after 1976. If you received a gift after 1976, your basis in the gift (the donor's adjusted basis) is increased by the part of the gift tax paid that is due to the net increase in value of the gift. This part is figured by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift, and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. In 1990, you received a gift of property from your mother. At that time the property had a FMV of $50,000 and her adjusted basis was $20,000. She paid a gift tax of $9,000 on the property. For figuring depreciation, depletion, amortization, and gain or loss, your basis is $25,400 which is figured in the following way:

Fair market value	$50,000
Minus: Adjusted basis	20,000
Net increase in value	$30,000
Gift tax paid	$ 9,000
Multiplied by ($30,000 ÷ $50,000)	.60
Gift tax due to net increase in value	$ 5,400
Adjusted basis of property to your mother	20,000
Your basis in the property	$25,400

Property Transferred From a Spouse

If your spouse transfers property to you, or to a trust for your benefit, your basis in the property is the same as your spouse's adjusted basis.

If, incident to a divorce, property is transferred to you (or to a trust for your benefit) by your former spouse, your basis in the property is the same as the transferor's basis. However, your basis is adjusted for any gain recognized by the transferor on a transfer of property in trust in which the sum of the liabilities assumed, plus the liabilities to which the property is subject, is more than the adjusted basis of the property transferred.

The transferor must supply you with records necessary to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information on the transfer of property between spouses, see Publication 504, *Tax Information for Divorced or Separated Individuals.*

Inherited Property

Your basis in property you inherit is usually its FMV at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its FMV at the alternate valuation date, if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if elected for estate tax purposes.

For more information, see *Inherited Property* in Publication 551.

4. Determining Your Income

This chapter discusses accounting periods and methods, and how to figure gross income. Every person who is subject to federal income tax must have an accounting period and an established accounting method. After you have selected your accounting period and method, you must use them to figure your gross income. For more information on accounting periods and methods, see Publication 538, *Accounting Periods and Methods.*

Accounting Periods

Every taxpayer must figure taxable income, and file a tax return, on the basis of an annual accounting period called a tax year.

Calendar or fiscal year. A tax year is usually 12 consecutive months. It may be a calendar year or a fiscal year. A calendar year is 12 consecutive months ending on December 31. Most fishermen use the calendar year. A fiscal year is 12 consecutive months ending on the last day of any month other than December.

Partnerships. A partnership must conform its tax year to the tax year of either its majority partners, its principal partners, or a tax year that results in the "least aggregate deferral of income" to the partners, in that order, unless it can establish a business purpose for using a different tax year, or makes a section 444 election. See Publication 541, *Tax Information on Partnerships.*

Establishing the tax year. If you have never filed an income tax return before, you may adopt either a calendar or a fiscal year. In certain situations, however, you will have to adopt the calendar year as your tax year. For example, if you do not maintain a set of books and records, you must

use the calendar year. You also must use the calendar year if you have no annual accounting period or the one you have does not qualify as a fiscal year. The first tax year must be adopted by the time set by law, not including extensions, for the filing of a return for that tax year.

Changing your tax year. You must, with certain exceptions, get the approval of the Internal Revenue Service (IRS) to change your tax year by filing Form 1128, *Application to Adopt, Retain, or Change a Tax Year.* This form must be filed by the 15th day of the 2nd calendar month after the close of the short tax year. This short tax year begins with the first day after the end of your present tax year and ends on the day before the opening date of your new tax year.

If your application is approved, you must file an income tax return for the short tax year. There are special rules for figuring the tax for a short tax year caused by a change in your tax year. See Publication 538.

Accounting Methods

The purpose of an accounting method is to show income and expenses accurately. If this is achieved, it is a satisfactory method of accounting for income tax purposes. You must file your return using the same method as you use in keeping your records. The most common accounting methods are:

1) The cash method, and
2) The accrual method.

You may also use any combination of these methods that meets the needs of your business as long as your income is clearly shown. However, if inventories are necessary in accounting for your income, you must use the accrual method for your sales and purchases. Only the cash method is discussed here. See Publication 538 for information on the accrual and other accounting methods.

Choosing your accounting method. In filing your first return, you may adopt any permissible accounting method without the consent of the IRS. You must use the same method from year to year and figure your taxable income following the accounting method you use to keep your books if that method clearly shows your income.

Cash method. With the cash method, you include in your gross income all items of income you ***actually or constructively receive*** during the year. Usually, you must deduct expenses in the tax year in which you pay them. However, you may get special treatment for expenses that you pay in advance.

You have constructive receipt of income when an amount is credited to your account or made available to you without restriction as to the time or manner of payment. You do not need to have possession of it.

Example. You sell fish daily to a local fish house and you receive the payment on Saturday of each week. On Saturday, December 29, 1990, you did not pick up the payment and the fish house ticket. You picked up the payment on January 2, 1991. The payment is included in your gross income for 1990 because it was available to you in that year.

Delaying receipt of income. You cannot hold checks or similar property from one tax year to another to avoid paying the tax on the income. You must report the income in the year the property is received or available to you without restriction. If you authorize someone to be your agent and receive income for you, you are treated as having received that income when your agent receives it.

Expenses paid in advance. Expenses you pay in advance can be deducted only in the year to which they apply.

Example. You are a calendar year taxpayer and you pay $1,000 for an insurance policy that is effective on July 1, 1990, for a one-year period. You may deduct $500 in 1990, and $500 in 1991.

Two or more businesses. If you own more than one business, you may use a different accounting method for each separate and distinct business if the method you use for each clearly shows your income. No business will be considered separate and distinct if you do not keep a complete and separate set of books and records for that business.

Example. You operate a fishing vessel and a retail grocery. You may use the cash method for the fishing business, but you must use the accrual method for the grocery business because inventories are necessary in accounting for income in this kind of business.

Limits on use of cash method. The cash method of accounting may not be used by:

1) Corporations (other than S corporations),
2) Partnerships having a corporation (other than an S corporation) as a partner, and
3) Tax shelters. An exception allows entities, except tax shelters, with average annual gross receipts of $5,000,000 or less over the last 3 tax years to continue using the cash method. See Publication 538.

Changing your method of accounting. When you file your first return, you may, without the consent of the IRS, choose any appropriate method of accounting. The method you choose must clearly show your income and this same method must be used from year to year. After that, if you want to change your method of accounting, you must first get the consent of the IRS.

A change in the method of accounting includes a change not only in your overall system of accounting but also in the treatment of any material item. For examples of changes requiring consent and the rules on how to get consent, see Publication 538. See also Form 3115, *Application for Change in Accounting Method.*

Gross Income

Any income you receive, regardless of its source and whether it is in the form of cash, property, or services, must be reported on your tax return (Form 1040), unless it is specifically excluded by law.

Trades and exchanges. If you exchange property for services, services for services, or services for property, you must report the fair market value of the property or services you receive. This is called ***barter income.*** It includes such exchanges as fish for services or groceries, or the exchange of your services for fish or the services of another.

Reporting income. You report on Form 1040 your net profit from your fishing business as well as any compensation for services, interest, dividends, rents, royalties; income from partnerships, estates, and trusts; and profits from the sales or exchanges of property that you may have received. You may also have to include a refund of excise taxes in income, as discussed in Publication 378, *Fuel Tax Credits and Refunds.*

One important source of income for you is from your fishing business (net profit shown on Schedule C (Form 1040)). Your gross sales or gross receipts is the first figure you must have to determine the results of your fishing business. Usually the sales figure on your income tax return will be taken from your annual summary for Schedule C entries. See Chapter 15.

Gross income from fishing. Your gross income from fishing includes any income you receive from the catching, taking, harvesting, cultivating, or farming of any kind of fish, shellfish (such as clams and mussels), crustacea (such as lobsters, crabs, and shrimp), sponges, seaweeds, or other aquatic forms of animal and vegetable life.

Exclusions. Some items specifically excluded from gross income are:

1) Increase in value of business assets, if no sale or exchange takes place, except for items included in inventories,
2) Interest on tax-exempt obligations of any state, possession of the United States, or any political subdivision of the United States, or of the District of Columbia (interest on U.S. Savings Bonds is not tax-exempt),
3) Loans from banks or individuals and money, other than interest, you received from others in repayment of loans receivable, unless you previously charged off the loan and the charge-off resulted in a decrease in your tax for any year,
4) Social security benefits from the federal government or from a state under the federal social security program if they are under a certain amount (see Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits*), and
5) War veterans' pensions and similar kinds of compensation (retirement pay based on age or length of service is not excluded).

5. Business Expenses

Important Change for 1990

Standard mileage rate. The standard mileage rate for 1990 is 26 cents a mile for all business miles put on a truck or car. Beginning in 1990, you are not subject to the 15,000 mile annual limit which applied in prior years.

A person who operates a fishing business for profit may deduct all the ordinary and necessary expenses of carrying on the fishing business. The word ***ordinary*** refers to an expense that is a common and accepted practice in the commercial fishing industry. ***Necessary*** means that the expense is appropriate and helpful in developing and maintaining your fishing business. Some of the most common business expenses for a fishing business are discussed later in this chapter. For a discussion of depreciation, see Chapter 6.

Whether a fishing business is being operated for profit must be determined from all the facts and circumstances in each case. However, you will not ordinarily be considered as operating a fishing business for profit if you fish mainly for personal consumption, but derive some income from incidental sales. If you are not engaged in fishing for profit, you must still include any income you have from that activity on your return.

Not-for-Profit Fishing

If your fishing activity is not carried on to make a profit, the deductions you can take for it are limited and no loss will be allowed to offset other income. In determining whether or not you carry on your fishing activity for profit, your intentions are important, but all factors relating to your activity must be taken into account. No one factor or group of factors is decisive.

The deductions that you may take are allowed only in the following order, subject to certain limitations, and only if you itemize them on Schedule A (Form 1040).

1) Deductions that you can take for personal as well as for business activities.
2) Deductions that do not result in an adjustment to the basis of property.
3) Business deductions that decrease the basis of property.

See Chapter 1 of Publication 535, *Business Expenses.*

Presumption that an activity is for profit. Your fishing activity is presumed to be carried on for profit if it produced a profit in at least 3 of the last 5 tax years. The 5–year period must include the current year. If your activity passes this test, it will not come under the limits discussed here. You can deduct all of your business expenses from the fishing activity, even for the years that you have a loss. See Chapter 1 of Publication 535 for more information.

Taxes

You may deduct various taxes imposed by federal, state (including certain Indian tribal governments), local, and foreign governments that you incur in the ordinary course of your fishing business and that are directly attributable to the business. Other taxes not related to your fishing business are deductible only if you choose to itemize deductions on Schedule A (Form 1040). If you use the cash method of accounting, your deduction for taxes may be taken only in the year the taxes are paid.

Deductible taxes. Some taxes that you may deduct are briefly discussed below.

Real property taxes. Usually you may deduct all taxes imposed on real property you own (such as a gear shed or net loft). Because many fishermen have only personal property for business assets (a boat, etc.), they pay no real property tax on business property. Therefore, no business expense deduction for real property taxes is allowable to these fishermen. However, if you own your home, the real estate taxes you pay on it are deductible on Schedule A (Form 1040) if you choose to itemize your deductions.

State or local income taxes. If you operate your fishing business as a sole proprietorship, the state income taxes that you pay are not deductible as business expenses. They are deductible as itemized deductions on Schedule A (Form 1040).

A state tax on gross income that is directly attributable to your fishing business is deductible as a business expense.

Employment taxes. You can deduct federal unemployment taxes (FUTA) and the employer's part of social security taxes (FICA) as business expenses. For more detailed information on employment taxes, see Chapter 11.

Other taxes. A fisherman may deduct as a business expense any tax imposed by a state or local government on personal property used in the fishing business. Normally, personal property taxes are based on the value of the property. However, they may be based on weight or some other measure and still be deductible as business expenses.

Although the itemized deduction for state and local sales taxes on Schedule A (Form 1040) has been eliminated, you may still deduct any sales tax you pay in your fishing activity to the extent that the expense itself is deductible. For example, any sales tax paid as part of a business meal is deductible as part of the meal expense subject to limitations, discussed later, on meals in general. Any sales tax you pay to acquire or dispose of depreciable property must either be included in the basis of the property or deducted from the amount realized for the property.

Nondeductible taxes. Federal income, estate, and gift taxes and state inheritance, legacy, and succession taxes are never deductible.

Repairs

The cost of repairing, replacing, or improving property used in your fishing business is either a deductible expense or a capital expense.

Capital expenses. A capital expense is an investment of capital either to acquire property with a useful life of more than one year or to make permanent improvements that increase the value of the property or appreciably prolong its life. Included in capital expenses are such things as commissions paid to acquire property and court costs in perfecting title.

Example. You maintain a slip and dock for your ships. When it was built, the sides of the dock were riprapped. Later you discovered that because of the propeller action of the ships using the slip, the riprap did not stay in place, requiring substantial annual expenses for maintenance of the dock.

To correct the situation and to eliminate the annual maintenance costs, you had the slip on the dock side sheet piled. The cost of the sheet piling was three times the annual maintenance cost. The sheet piling was a permanent improvement to the dock and a capital expense, as distinguished from an annual maintenance cost. The cost is recovered by annual depreciation allowances for real property. See Chapter 6.

Repairs. Repairs do not add to the value or usefulness of the property nor do they appreciably lengthen its life. They merely maintain the property in a normal efficient operating condition. The cost of repairs, including labor, supplies, and certain other items, is a deductible expense. However, the value of your own labor is ***not*** deductible.

Examples of common repairs are the cost of material and labor to paint your boat, mend your nets, or replace a deck plank.

Replacements. You may not deduct the cost of a replacement that stops deterioration and adds to the life of your property. It should be capitalized and depreciated.

Amounts you pay to replace ***parts*** of an engine that only keep it in normal operating condition are deductible business expenses. However, if the engine has a major overhaul, the expense is capitalized and depreciated.

Improvements. Improvements add to the value of property, lengthen its life, or adapt it to a different use. The cost of an improvement is a capital expense. It may not be deducted in full as a current business expense. Ordinarily, the cost of the improvement is added to the basis of the improved property and depreciated. Examples of improvements are a new refrigeration unit or a new engine for your boat.

The cost of reconditioning, improving, or altering your property as part of a general restoration plan to make it suitable for your business must be capitalized. This applies even if some of the work would by itself be classified as repairs.

Example. You bought a fishing boat that needed extensive repairs. To meet safety requirements and to make the boat usable in your business, you spent $10,000 repairing or replacing old engine parts, worn-out equipment, and deteriorated sections of the hull. The $10,000 must be capitalized.

Business motor vehicles. The cost of a motor vehicle you buy to use in your business must usually be capitalized. You can recover its cost through annual deductions for depreciation, as discussed in Chapter 6.

Repairs you make to your business vehicles are deductible. However, amounts you pay for reconditioning and overhaul of business vehicles are capital expenses.

Tools. Unless the uniform capitalization rules apply, amounts spent for tools used in your business are deductible as business expenses if the tools wear out and are thrown away within one year from the date of purchase or if their cost is minimal.

Salaries, Wages, Etc.

Salaries, wages, and other forms of compensation paid to employees generally are deductible business expenses if they are:

1) Ordinary and necessary expenses of carrying on your fishing business,
2) Reasonable in amount,
3) For personal services actually performed, and
4) Actually paid or incurred during the tax year.

As a sole proprietor, you may not deduct your own salary or any other withdrawals you make for your personal use. However, wages paid to your relatives, including a minor child, are deductible if the four requirements above are met.

The deduction for salaries and wages must be reduced by the dollar amount of the jobs credit determined for the tax year. See Form 5884, *Jobs Credit,* for more information.

Noncash payments. Compensation need not be paid in cash. It may be in the form of meals, lodging, or a part of the catch. If your crew members receive a part of the catch for their services, you are entitled to deduct the fair market value of the fish on the date given, and your crew members are required to include this amount in their incomes. You also must include in your gross income the fair market value of the fish given to your crew members. If your crew members receive a part of the catch for their services, the value of their part may be subject to income tax withholding, FICA, and FUTA. See Chapter 11.

Meals and lodging. Generally, you may deduct the costs you incur in furnishing meals and lodging to your employees if the costs are includible in your employees' pay. However, if you reimburse your employees for the costs they incur for meals and entertainment, you may deduct only 80% of the reimbursement (see *Crew meals,* below), and only if the expense would otherwise be deductible as an ordinary and necessary trade or business expense.

Crew meals. The 80% limit does not apply to the expense for food or beverages that an employer provides to crew members of certain commercial vessels if the meals are required to be provided by Federal law (or would be required if the vessel operated at sea). This exception does not apply to vessels usually used for luxury water transportation such as cruise ships or passenger liners.

Exclusion from income. If the meals and lodging that you furnish your employees without charge meet the following three special tests, their value is excludable from the gross income of your

employees and is not subject to FICA, FUTA, and income tax withholding.

1) The meals or lodging must be furnished on your business premises;
2) The meals or lodging must be furnished for your convenience; and
3) In the case of lodging (but not meals), the employees must be required to accept it as a condition of their employment. This means that acceptance of the lodging is required to enable them to properly perform the duties of their employment, as when they must be available for duty at all times.

Retirement Plans

Retirement plans are savings plans that offer you tax advantages to set aside money for your retirement, and for your employees' retirement. There are two kinds of retirement plans that a self-employed individual can set up—a Keogh (H.R. 10) retirement plan and a simplified employee pension (SEP). Also, in general, individuals who work can set up individual retirement arrangements (IRAs).

Within certain limits, you can take a business deduction on line 19 of Schedule C (Form 1040) for the contributions you make to a plan for your employees. You can also deduct contributions made for your spouse if a ***true employer-employee relationship*** exists between you and your spouse. You take a personal deduction as an adjustment to income on Form 1040 for allowable contributions you make for yourself.

Keogh plans. Generally, a Keogh plan can be set up by a sole proprietor or a partnership. The plan must be written, and it must cover all your employees who have satisfied minimum service requirements. The plan also must meet certain other requirements to qualify. For this purpose, sole proprietors and partners who perform personal services that are a material income-producing factor are treated as employees.

If your plan is a profit-sharing plan, you can contribute on your own behalf and deduct on Form 1040 up to $30,000 or 15% of your net earnings from self-employment, whichever is less. If the plan is a money purchase plan, you can contribute up to $30,000 or 25% of net earnings, whichever is less. However, special rules apply in figuring your net earnings and the deduction for yourself for Keogh plan purposes. See *Employer Deduction* under *Keogh Plans* in Publication 560.

Fishermen treated as self-employed. Fishermen may be considered self-employed for Keogh plan purposes. A fisherman is considered self-employed for this purpose if he or she serves on a fishing boat in an arrangement under which the only pay is in the form of a share of the boat's (or boats') catch, or a share of the proceeds from the sale of the catch. The share must depend on the amount of the boat's (or boats') catch. Also, the operating crew of the boat (or each boat) must normally be made up of fewer than 10 persons.

For more information on Keogh plans, see Publication 560, *Retirement Plans for the Self-Employed.*

Individual retirement arrangement (IRA). You can set up and contribute to an IRA if you have taxable compensation and have not reached age 70 1/2 by the end of the year.

Contributions. The most you can contribute for any year to your IRA is the smaller of:

- $2,000, or
- Your taxable compensation for the year.

Deductible contributions. The amount you can ***deduct*** on your return for any year depends on whether you or your spouse (unless you file separately and live apart throughout the tax year) is covered by an employer retirement plan, your filing status, and the amount of your income. Even if you cannot make deductible contributions, you may be able to make nondeductible contributions to your IRA. For details on these and other rules, as well as general information on IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs).*

Simplified employee pension. A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make contributions toward his or her retirement (if a self-employed individual) and employees' retirement. A SEP allows an employer to make contributions directly to an IRA (SEP–IRA) set up for each participating employee. A self-employed person is an employee for this purpose, and can have a SEP–IRA. Under a SEP, an employer can contribute up to the smaller of $30,000 or 15% of an employee's compensation to the participating employee's SEP–IRA. Employees do not include employer contributions in income.

In addition, you, the self-employed employer, and your employees can contribute to your SEP–IRAs independent of your regular employer SEP contributions. These contributions are subject to the rules discussed earlier under *Individual retirement arrangement (IRA).*

The contributions you make to a SEP–IRA are treated as if made to a qualified (meeting Internal Revenue Code requirements) plan. The maximum amount you can deduct on Schedule C (Form 1040) for employer contributions to a SEP is 15% of the common-law employee compensation (determined without regard to your contributions). A self-employed person's maximum deduction is, because a special computation is required, 13.0435% of his or her compensation. Deduct contributions for you on line 27 of Form 1040. Any amount you contribute to a SEP–IRA that is more than the limit for a tax year can be carried over and deducted in later years. The most that may be contributed for a participant in any year is $30,000.

If you have both a SEP and a profit-sharing plan, you must reduce the 15%-of-compensation deduction limit for the profit-sharing plan by the SEP deductions. If your business has a SEP, a defined contribution plan, and a defined benefit plan, the 25%-of-compensation deduction limit for combinations of qualified plans must be reduced by the SEP deductions.

A SEP may include a salary reduction arrangement. Under the arrangement, your employee may choose to have you make contributions to the SEP in exchange for a reduction of his or her pay.

Employer's SEP contributions excluded from employee's wages on Form W–2. Your SEP contributions are excluded from an employee's income. Therefore, do not include these contributions in the employee's wages on Form W–2, *Wage and Tax Statement,* for income tax purposes.

These contributions are excluded from income for social security (FICA) and federal unemployment (FUTA) tax purposes. However, your SEP contributions under a salary reduction agreement are included in the Form W–2 wages for FICA tax purposes only. You also may have to take them into account for FUTA tax purposes if the employee is engaged in salmon or halibut fishing, or works on a vessel of more than 10 net tons (and is not treated as self-employed—see the discussion under *Keogh plans,* earlier).

The employee cannot take a deduction for your contributions.

For more information on SEPs, see Publication 590.

Truck and Car Expenses

You may deduct the cost of operating a truck or car if it is used in your fishing business. Only the expenses for business use are deductible. All operating and fixed costs for business use are deductible, including such items as gasoline, oil, repairs, license tags, insurance, and depreciation.

Standard mileage rate. You may use the standard mileage rate instead of deducting your actual operating and fixed expenses for your vehicle. The standard mileage rate is 26 cents a mile for all business miles put on your truck or car. Beginning in 1990, you are not subject to the 15,000 mile annual limit which applied in prior years.

If you want to use the standard mileage rate for a car in any year, you must choose to use the standard mileage rate in the first year you place your car in service in your business. In later years, you may use the standard mileage rate or actual expenses. If you do not choose the standard mileage rate in the first year, you may not use it for that car in any year.

If you use the standard mileage rate in the first year, you are considered to have made an election not to use the accelerated cost recovery system (ACRS) or the modified accelerated cost recovery system (MACRS). You also may not claim the section 179 deduction. If you change to the actual cost method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

To use the standard mileage rate, you must:

1) Own the vehicle,
2) Not use the vehicle for hire, such as for a taxi, and
3) Not use more than one vehicle at a time for business.

For more information on the standard mileage rate, see Publication 917, *Business Use of a Car.*

Commuting. Commuting expenses for travel between your residence and the place where you regularly dock your boat are not deductible.

Travel Expenses

Travel expenses are deductible if they are ordinary and necessary expenses you have in traveling away from home for your fishing business. However, you may not deduct these expenses if they are lavish or extravagant. Your home, for tax purposes, will usually be your home port where you begin and end your fishing trips. You are considered away from home if the period of absence from your home port is substantially longer than an ordinary work day and your duties require you to obtain sleep while away from your home port.

If you meet these requirements and you can prove the time, place, and business purpose of the travel, you may deduct your reasonable and necessary expenses for travel, meals, and lodging. See *Meals and lodging,* discussed earlier, for limitations on your deduction.

Travel expenses include such items as:

1) Meals and lodging,
2) Cleaning and laundry expenses,
3) Telephone and telegraph expenses,
4) Transportation charges from where you obtain your meals and lodging to your boat,
5) Other similar ordinary and necessary expenses related to travel, and
6) Tips incident to any of the above expenses.

Reimbursements to employees. Reimbursements and allowances to your employees for travel and transportation expenses incurred by them in the conduct of your business are deductible by you as business expenses (subject to the limitations discussed earlier, under *Meals and lodging*). If you require that your employees account to you for these expenses, you must keep the records and supporting documents given to you by your employees to prove the deductions on your return for the reimbursements or allowances you paid them. See *Recordkeeping requirements*, later.

Example. You take your boat and crew 200 miles from your home port to another port from which you intend to fish for 6 weeks. While in port, you and your crew stay in a motel and eat your meals in a restaurant. The crew members give you their receipts for meals and lodging. In this case the meals, lodging, and other incidental expenses for yourself and amounts paid to your crew to cover these expenses are deductible as travel expenses (subject to the limitations discussed earlier) if they are not lavish or extravagant.

Recordkeeping requirements. You must prove your deductions for travel, entertainment, and gift expenses by adequate records or by sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

Adequate records. You should keep the proof you need for travel, entertainment, and gift expenses in an account book, diary, statement of expenses or similar record, supported by adequate documentary evidence, that together will support each statement of an expense.

Instead of deducting the actual cost of meals while traveling away from home for business, you may choose to deduct a standard meal allowance. If you choose this option, you do not have to keep records to prove the amount spent for meals. However, you must still prove the actual cost of other travel expenses as well as the time, place, and business purpose of your travel.

Additional information. For additional information on travel and entertainment, including recordkeeping and the standard meal allowance amounts, see Publication 463, *Travel, Entertainment, and Gift Expenses.*

Insurance

You generally can deduct the cost of insurance premiums for your fishing business as an expense.

Some examples of deductible insurance premiums are:

1) Fire, theft, flood, and other casualty insurance on your business property (for example, hull insurance);
2) Liability insurance (protection and indemnity);
3) Workers' compensation insurance;
4) State unemployment insurance fund contributions;
5) Car and other vehicle insurance premiums on policies covering liability, damages, and other losses from accidents involving vehicles used in your fishing business (if the vehicles are used only partly for business, you may deduct only the part of your insurance premiums that are for the business use of the vehicle); and
6) Self-employed persons' ***medical insurance.*** If you are self-employed, or if you own more then 2% of the outstanding stock of an S corporation and receive wages from the corporation, you may be able to deduct, as an adjustment to income on Line 26, Form 1040, 25% of the amount paid on your behalf for health insurance for yourself and your family. This deduction is only for amounts paid before October 1, 1990, for coverage provided before that date.

However, when you are both self-employed and an employee of another person, you will not be allowed to deduct any medical insurance payments as an adjustment to income if you are eligible to participate in a subsidized plan maintained by your employer. This is true even if it is your spouse who is employed, and you are eligible to participate in your spouse's employer's plan. You may still be eligible to deduct them on Schedule A (Form 1040) if you itemize your deductions. See Chapter 8 of Publication 535 for more information.

Business insurance premiums ordinarily are deductible in the tax year to which they apply. You may deduct premiums you pay in advance only in the tax years to which they apply.

Example. You operate your own fishing boat and file your returns on a calendar year basis. You purchased a fire insurance policy on your boat effective October 1, and paid in advance a premium of $1,500 for 3 years. You may deduct $125 for the 3 months of insurance expense in the first year (¼ of ⅓ of $1,500), $500 in the 2nd year, $500 in the 3rd year, and $375 for the 9 months of insurance expense in the 4th year.

Interest

Interest is the amount you pay for the use of borrowed money. You may generally deduct all interest you pay or accrue in the tax year on a debt that is related to your fishing business. The interest must be on a debt under which you have a legal obligation to pay a fixed or determinable sum of money. For more information, see Chapter 6 of Publication 535.

Prepaid interest. Under the cash method, you cannot deduct any interest paid before the year it is due. Interest you pay that is properly allocable to a later tax year must be charged to a capital account. Treat an advance payment as paid in the period covered by the prepaid interest.

Under the accrual method, if you pay interest in advance, you can only deduct it as it accrues. This rule also applies to the amount subtracted on a discounted loan.

Other Business Expenses

The following are some of the other business expenses you may have in your fishing business.

Business start-up costs. If you set up or acquire an active fishing business, you may choose to amortize certain amounts you spend in connection with setting up the business or in connection with investigating the creation or acquisition of the business. You may amortize these costs over a period of 60 months or longer, starting with the month you start the business. If you dispose of the entire fishing business before the end of the 60–month (or longer) period, the unamortized costs may be deducted to the extent they qualify as a business loss. See Chapters 1 and 10 of Publication 535 for more information.

Using your home in your business. If you use part of your home ***exclusively and regularly*** as your principal place of business for any trade or business of yours or as a place where you meet or deal with clients or customers, you may deduct the expenses due to the business portion of your home.

A separate structure that is not attached to your residence, such as a garage, may qualify if it is used in connection with your business and if it is used exclusively and regularly for this purpose.

There is a limit on the amount of the deduction for operating expenses, depreciation, etc., that may be taken for the business use of your home. The total deduction for business use of your home cannot be more than the gross income from the business use of your home minus the sum of:

1) The business percentage of the otherwise deductible mortgage interest, real estate taxes, and casualty and theft losses, and
2) The business expenses that are not attributable to the business use of your home (for example, salaries or supplies).

You do not have to use a particular method of recordkeeping. However, you must keep records that provide the information needed to figure your deduction for the business use of your home. For additional information, see Publication 587, *Business Use of Your Home.*

Rent. Rent is the amount that you have to pay for the use of property that you do not own. In general, you may deduct rent as an expense only if the rent is for property that you use in your business. If you pay rent in advance, you may, for the tax year in which paid, deduct only the amount that applies to your use of the rented property during that tax year. The rest must be deducted over the period it covers.

Example. In May 1990, you leased moorage space for your fishing boat for 5 years beginning July 1, 1990, and ending June 30, 1995. You are to pay a yearly rental of $360. You paid the first year's rent ($360) on June 1, 1990. On your income tax return for calendar year 1990, you may deduct only ½ of $360, or $180, for the rent applicable to 1990.

Legal and professional fees. Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses of operating your fishing business are deductible as business expenses. However, if the charges include payments for work of a personal nature, such as making out a will, you may deduct as a business expense only the part of the fee that has to do with your business. Some of the other fees may be deductible on Schedule A (Form 1040) if you elect to itemize deductions. See Publication 529, *Miscellaneous Deductions.*

Miscellaneous expenses. Miscellaneous business expenses, such as galley supplies, bait, ice, and fuel for your boat, are deductible business expenses. Licenses and regulatory fees you pay annually to state or local governments also are deductible business expenses.

Losses From a Fishing Business

If you have a loss in the operation of your fishing business during the year, or you had a casualty or theft loss that was more than your income, you may have a net operating loss (NOL). You can use an NOL to reduce your income (and tax) in other years by carrying it to those years and deducting it from income you have in those years. However, the at-risk limits, discussed below, may limit how much of your NOL you can carry to the other years.

Net operating losses. If your deductions for the year are more than your gross income, you may have an NOL. However, there are rules that limit what deductions you can take when figuring an NOL. These rules are discussed under *How To Figure an NOL* in Publication 536, *Net Operating Losses.*

It is important for you to determine whether you have an NOL. If you have an NOL this year, you may be able to get a refund of part or all of the income tax you paid for the past 3 tax years or you may be able to reduce your tax in future years.

Carrybacks. You generally carry an NOL back to the 3 tax years before the NOL year and deduct it from income you had in those years. There are rules for figuring how much of the NOL is used in each tax year and how much is carried to the next tax year. These rules are explained under *How To Use an NOL* in Publication 536.

Unless you choose to forgo the carryback period (as discussed later), you must first carry your NOL to the third tax year before the NOL year. If it is not all used up that year, carry the unused part to the next year, the second year before the NOL year. If it is not all used up in the second year, carry the remaining unused part to the next tax year, the year before the NOL year.

Refigure your deductions, credits, and tax for each of the 3 carryback years to which you carried an NOL. If your refigured tax is less than the tax you originally paid, you can apply for a refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return*, for each year affected or by filing Form 1045, *Application for Tentative Refund*. You will usually get a refund quicker by filing Form 1045, and you can use one Form 1045 to figure the overpayments of tax for all 3 carryback years.

Carryovers. If you do not use up the NOL in the 3 carryback years, carry what remains of it over to the next 15 tax years following the NOL year. Carry it to the first tax year after the NOL year. If you do not use it up in that year, carry the unused part over to the next year. Continue to carry over any unused part of the NOL from year to year until you complete the 15-year carryover period.

Forgoing the carryback period. You can choose not to carry back your NOL. If you make this choice, you may then use your NOL only in the 15-year carryover period. To make this choice, attach a statement to your tax return for the year you have the NOL showing that you choose to forgo the carryback period. For more information about making the choice, see *Forgoing the carryback period* under *When To Use an NOL* in Publication 536.

Partnerships and S corporations. Partnerships and S corporations are not allowed to take an NOL deduction. But the partners or shareholders may use their separate shares of the partnership's or S corporation's loss to figure their individual NOLs.

At-risk limits. Rules that limit your deduction for losses apply to most business or income-producing activities. Fishing is one of the activities covered. The at-risk rules limit the amount of loss you may deduct when figuring your taxable income or an NOL. The deductible loss from an activity is limited to the amount you are considered to have at risk in the activity.

You are generally considered to be at risk up to the amount of money and property you contribute to an activity, plus certain amounts borrowed for use in the activity. You are considered at risk for amounts borrowed for use in the activity if you are personally liable for repayment of the amounts borrowed or if the amounts borrowed are secured by your property that is not used in the activity. You are not considered at risk, however, for amounts borrowed for use in a farming activity from a person who has an interest in the activity or a related person to someone (other than you) having such an interest. For more information, see Publication 925, *Passive Activity and At-Risk Rules*.

Passive activity limits. If you are involved in a passive activity, special rules limit the loss you can deduct in the tax year. Losses from passive activities that exceed income from all other passive activities generally cannot be deducted in the tax year. Credits are similarly limited.

A ***passive activity*** is generally any activity involving the conduct of any trade or business in which you do not materially participate. A rental activity is also a passive activity.

There are special rules for interests in activities acquired before October 23, 1986, and certain rental activities. For more information, get Publication 925.

Nondeductible Expenses

Fines and penalties for violation of federal or state laws are not deductible even if they are called adjustments or any other name, and even though the violations are inadvertent. Fines and penalties paid to a foreign government for the violation of that country's laws are not deductible.

Bribes and kickbacks. You may not deduct bribes, kickbacks, or similar payments if they are either of the following:

1) They are payments made directly or indirectly to an official or employee of any government or an agency or instrumentality of any government in violation of the law. If the government is a foreign government, the payments are not deductible if they are unlawful under the Foreign Corrupt Practices Act of 1977.
2) They are payments made directly or indirectly to a person in violation of any federal or state law (but only if that state law is generally enforced) that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

6. Depreciation

If you buy business property that has a useful life of more than a year, you generally cannot deduct its entire cost in one year. Instead, you must spread the cost over more than one year and deduct a part of it each year. For most types of property, this is called "depreciation."

The discussion in this chapter gives you basic information on the section 179 deduction and the modified accelerated cost recovery system (MACRS) that apply to property placed in service after 1986.

Use Form 4562, *Depreciation and Amortization*, to report your depreciation deduction, including the section 179 deduction.

File Form 4562 only if:

1) You are claiming depreciation on property placed in service this year,
2) You are claiming a section 179 deduction,
3) You are beginning to claim amortization this tax year,
4) You are claiming depreciation on any listed property, or
5) You are filing a corporate tax return.

If you do not have to file Form 4562, claim depreciation on the appropriate line of your tax return.

If you need information on the depreciation methods for property used before 1987, see Part III of Publication 534, *Depreciation*.

What Can Be Depreciated

Many different kinds of property can be depreciated, for example, machinery, buildings, vehicles, patents, copyrights, furniture, and equipment.

Property is depreciable if it meets all three of these tests:

1) It must be used in business or held for the production of income (for example, to earn rent or royalty income).
2) It must have a determinable life and that life must be longer than one year. The life of a piece of property is an estimate of how long you can expect to use it in your business or to earn rent or royalty income.
3) It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

Depreciable property may be ***tangible*** or ***intangible.*** Tangible property is any property that can be seen or touched. Intangible property is property, such as a copyright or franchise, that is not tangible. It may qualify for amortization. Amortization is a method that permits you to deduct certain capital expenditures in a way similar to depreciation. See Chapter 10 in Publication 535, *Business Expenses*. Depreciable property may be ***real*** or ***personal.*** Personal property is property, such as machinery or equipment, that is not real estate. Real property is land and generally anything that is erected on, growing on, or attached to land. However, ***land itself is never depreciable.***

Rented property. If you pay rent on property, you cannot depreciate that property. Only the owner may depreciate it. If you make permanent improvements to the property you rent, you depreciate those improvements under MACRS.

Pots, traps, and nets. You depreciate pots, traps, and nets if you can use them for more than one year in your business. In most cases, you should capitalize and depreciate nets. Because the type and usage of pots and traps varies considerably from one fishery to another, no single rule can be made that will apply to all fishermen. You will have to use your own experience to determine if it is proper to capitalize the cost of this equipment and depreciate it or deduct it as a business expense.

Equipment used to build capital improvements. You cannot deduct depreciation on equipment that you are using to build your own capital improvements. Depreciation on this equipment during the period of construction must be added to the basis of the improvements. See *Uniform Capitalization Rules* in Publication 551, *Basis of Assets*.

Repairs. You cannot deduct, in one tax year, the entire cost of repairs or replacements you make to depreciable property if it increases the value of the property, makes it more useful, or lengthens its life. You must capitalize these costs and depreciate them.

Partial business use. If you use property both for business and personal purposes, you can only depreciate the business part. If you use part of your home for business, you may be able to take a depreciation deduction for this use. See Publication 587, *Business Use of Your Home*. See Publication 917, *Business Use of a Car*, for a discussion of car expenses.

Listed property placed in service or leased after June 18, 1984. There are limits on the depreciation deductions you may claim on "listed property" placed in service after June 18, 1984. These limits apply if the property is not used more than 50% in a qualified business use during any tax year. If leased after June 18, 1984, limitations are imposed on lessees that are "substantially equivalent" to those imposed on owners. See *Partial Business Use of Listed Property* in Part II of Publication 534. In addition, for passenger automobiles there is a dollar limit on the deduction you may claim each year. See Publication 917 for a discussion of these limits.

Listed property. Listed property includes:

1) Any passenger automobile.
2) Any other transportation vehicle (including boats).

3) Any property of a type generally used for entertainment, recreation, or amusement.
4) Any computer and related peripheral equipment.
5) Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

Depreciation not deducted in an earlier year. If, in an earlier year, you did not claim depreciation you were entitled to deduct, you must still reduce your basis in the property by the amount of the depreciation you did not deduct. You may not deduct the ***unclaimed depreciation*** in the current year or any later tax year. However, you may claim the depreciation on an amended return (Form 1040X) for the earlier year. An amended return must be filed within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

Section 179 Deduction

You may elect to treat all or part of the cost of certain qualifying property as an expense rather than as a capital expenditure. You must decide for each item of qualifying property whether to deduct, subject to the yearly limit, or capitalize and depreciate its cost. If you make the election for a deduction, a limited amount of the cost of qualifying property you buy for use in your trade or business is deductible in the first year you place the property in service. Placed in service is defined later under *Figuring Depreciation.*

Deduction limit. The total cost you may elect to deduct in 1990 may not exceed $10,000. The $10,000 maximum applies to each taxpayer and not to each business operated by a taxpayer.

While the maximum dollar amount that may be deducted is $10,000, there are certain provisions that can reduce this maximum.

Investment limit. For each dollar of cost of section 179 property placed in service in excess of $200,000 in a tax year, the $10,000 maximum is reduced (but not below zero) by one dollar.

Example. In 1990, James Smith placed in service machinery with a cost of $207,000. Since the cost of the machinery exceeds $200,000 by $7,000, he must reduce the maximum deduction allowed ($10,000) by $7,000. He is therefore entitled to a section 179 deduction for 1990 of $3,000.

Taxable income limit. The total cost that may be deducted in each tax year is limited to the taxable income which is from the active conduct of any trade or business during the tax year. Taxable income is figured as usual but without a deduction for the cost of any section 179 property and the deduction for half the self-employment tax. You cannot use a section 179 deduction to increase or create a net operating loss.

Any cost that is not deductible in one tax year under section 179 because of this limit may be carried to the next tax year and added to the cost of qualifying property placed in service in that tax year.

Example. Joyce Jones places in service in 1990 a machine that cost $8,000. The taxable income from her business for 1990 (determined without the cost of the machine or the deduction for half the self-employment tax) is $6,000. Her section 179 deduction is limited to $6,000. The $2,000 cost that is not allowed because of the taxable income limit can be carried to 1991.

See *Carryover of unallowable deduction* in Publication 534 for information on figuring the carryover.

Married taxpayers filing separate returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for the $10,000 maximum and for the $200,000 investment limit. Unless they elect otherwise, 50% of the cost of section 179 property, before the taxable income limit is applied, will be allocated to each.

Passenger automobiles. For passenger automobiles placed in service in 1990, your total section 179 deduction and depreciation cannot exceed $2,660 in 1990. See Publication 917 for more information.

Partial business use. When you use property for both business and nonbusiness, you are eligible to elect the section 179 deduction only if more than 50% of the property's use in the tax year the property is placed in service is for trade or business purposes. However, you must allocate the cost of the property to reflect only the business use of the property. This is done by multiplying the cost of the property by the percentage of business use. Use this adjusted cost to figure your section 179 deduction.

Cost. The cost of property for the section 179 deduction does not include any part of the basis of the property determined by reference to the basis of other property held at any time by the person acquiring the property. For example, if you buy a new truck to use in your business, your cost for the section 179 deduction does not include the adjusted basis of the truck you trade in on the new vehicle.

Election. You must make an election to take the section 179 deduction. You make this election in the first tax year the property is placed in service.

Use Form 4562 to make your election and report your section 179 deduction. Make this election by taking the deduction on Form 4562 filed with your original tax return. The election cannot be made on an amended return filed after the due date (including extensions), and once made, the election can be revoked only with the consent of the Internal Revenue Service (IRS).

Qualifying property. You may claim the section 179 deduction on depreciable property that is "section 38 property" and that is bought for use in the active conduct of your trade or business. You cannot take depreciation to the extent that you elect to expense the cost of your property.

Section 38 property. This includes property used in a trade or business with a useful life of 3 years or more for which depreciation or amortization is allowable and that basically is tangible personal property, or other tangible property, including certain real property, used as an integral part of manufacturing, production, or extraction, or used as a research or bulk storage facility for fungible commodities for these activities. For a more detailed definition, see *Section 179 Deduction* in Part I of Publication 534.

The determination of whether property is qualifying property is made in the first tax year the property is placed in service. Therefore, if you place property in service in a tax year and the property does not qualify for the section 179 deduction, no section 179 deduction is allowed for it even though it becomes qualifying property in a later tax year.

Example. In 1989, you bought a new car and used it entirely for personal purposes. In 1990 you begin to use the car in your business. No section 179 deduction is allowed for the car.

Nonqualifying property. The following property does not qualify for the section 179 deduction: (1) property acquired by one member from another component member of the same controlled group, (2) property whose basis is determined by reference to the adjusted basis of the person from whom acquired or which is acquired from a decedent, or (3) property you acquire from a related person if your relationship to the related person would result in the disallowance of losses.

Figuring the deduction. For 1990, the maximum section 179 deduction is $10,000 of the cost of property you buy for use in your trade or business. You decide how much of the cost of property you want to deduct under section 179. You do not have to claim the full $10,000. Any cost not deducted under section 179 may be depreciated.

If you have more than one item of property, you can allocate the deduction between the items. If you have only one item of qualifying property and that item costs less than $10,000, such as $3,200, your deduction is limited to $3,200.

Subtract the amount you elect to deduct from the basis of the qualifying property. Use this adjusted basis to compute your depreciation deduction.

Example. In 1990, you bought a $32,000 boat and a dinghy for $7,300 for use in your fishing business. Both items are placed in service in 1990. You elect to deduct the entire $7,300 for the dinghy and $2,700 for the boat, a total of $10,000. This is the most you can deduct in 1990. Your $7,300 deduction for the dinghy has completely recovered the cost of that item. The cost of your boat is adjusted by $2,700. Its basis for depreciation is $29,300. This is figured by subtracting the amount of your section 179 deduction, $2,700, from the cost of the boat, $32,000.

Recapture of section 179 deduction. If you deducted the cost of qualifying property placed in service ***after 1986*** and the property is not used more than 50% in a trade or business for any tax year before the end of the property's recovery period, you must include in income the benefit you got from the deduction.

Report any recapture of the section 179 deduction on Form 4797, *Sales of Business Property.*

Figure the amount to be included in income by subtracting from your section 179 deduction the depreciation that would have been allowable on the section 179 amount for prior tax years and the tax year of recapture.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on December 1, 1988, an item of 3–year property costing $10,000. The property is not listed property. He used the property only for business in 1988 and 1989. He elected a section 179 deduction of $5,000 for this property. During 1990, he used the property 40% for business and 60% for personal use. Had he not elected to expense $5,000 in 1988, he would have been entitled to deduct $1,666.50 (33.33% of $5,000) in 1988 and $2,222.50 (44.45% of $5,000) in 1989. In 1990, he would have been entitled to deduct 40% of $740.50 (14.81% of $5,000) or $296.20. Therefore, he must include in income for 1990 the excess of $5,000 over $4,185.20 ($1,666.50 + $2,222.50 + $296.20) or $814.80.

Dispositions. If you dispose of qualifying property, the amount you elected to deduct is subject to recapture as ordinary income. See Publication 544, *Sales and Other Dispositions of Assets.*

Figuring Depreciation

Before figuring depreciation deductions, you must know:

1) What your basis in the property is,
2) When the property was placed in service, and
3) Which method of depreciation you use.

Basis. Basis is a measure of your investment in the property you own. When you depreciate property, a certain percentage of your basis in it is deducted each year.

For property that you buy, your original basis is usually its cost to you. For property that you

acquire in some other way, such as by inheriting it, receiving it as a gift, building it yourself, or getting it in a tax-free exchange, figure your original basis in some other way.

While you own the property, various events may take place that will change your basis. Some events, such as additions or permanent improvements to the property, increase basis. Others, such as casualty losses and the section 179 deduction, decrease basis. See Chapter 3 for more information on how to figure basis.

Nonbusiness property changed to business use. When you change property that was not used for business to a business use, you must determine your basis in the property for figuring depreciation. This amount is determined as of the date of the change. It is the fair market value of the property on that date or your adjusted basis in the property on that date, whichever is less.

Placed in service. Property is considered placed in service when it is first ready and available for its specified use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS), also referred to as the "General Depreciation System" or "GDS," generally applies to all tangible property placed in service after 1986. However, you could have made a property by property election to use MACRS for property placed in service after July 31, 1986, and before January 1, 1987.

Property classes. Each item of property depreciated under MACRS is assigned to a property class. The property class of an item of property establishes the number of years over which the basis of the property is recovered. This period of time is called the recovery period.

Recovery periods. Under MACRS, tangible property that you place in service after 1986, or after July 31, 1986, if elected, falls into one of the following classes.

3-year property. This class includes tractor units for use over the road. This property is depreciated over 3 years.

5-year property. This class includes trucks, computers and peripheral equipment, office machinery (typewriters, calculators, etc.), and any automobile. This property is depreciated over 5 years.

7-year property. This class includes office furniture and fixtures (desks, files, etc.). This class also includes any property that does not have a class life and that has not been designated by law as being in any other class, such as nets, pots, traps, and boats used in commercial fishing. This property is depreciated over 7 years.

10-year property. This class includes vessels, barges, tugs, and similar water transportation equipment. This property is depreciated over 10 years.

15-year property. This class includes wharves and docks. This property is depreciated over 15 years.

20-year property. This class includes any municipal sewer. This property is depreciated over 20 years.

Nonresidential real property. This class includes any real property that is not residential rental property (defined next), and section 1250 property with a class life of 27.5 years or more. This property is depreciated over 31.5 years.

Residential rental property. This class includes any real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If you occupy any part of the building or structure, the gross rental income includes the fair rental value of the part you occupy. This property is depreciated over 27.5 years.

The class lives and recovery periods for most assets are listed in the *Table of Class Lives and Recovery Periods* in Part II of Publication 534.

MACRS deductions. You may determine your MACRS depreciation deduction in one of two ways. You can use the percentage tables, discussed later. Or you can actually compute the deduction using the applicable depreciation method and convention over the recovery period. The deduction is the same under both methods.

Depreciation methods. For property in the 3–, 5–, 7–, or 10–year class, you use the double (200%) declining balance method over 3, 5, 7, or 10 years and a half-year or mid-quarter convention (defined later). For property in the 15– or 20–year class, you use the 150% declining balance method over 15 or 20 years and a half-year or mid-quarter convention. For these classes of property, you change to the straight-line method for the first tax year for which that method when applied to the adjusted basis at the beginning of such year will yield a larger deduction. You always use the straight-line method for nonresidential real and residential rental property.

Straight-line election. Instead of using the declining balance method, you may elect to use the straight-line method with a half-year or mid-quarter convention (defined later) over the recovery period. The election to use the straight-line method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering "S/L" in column (f) of Part II of Form 4562. The election must be made by the due date (including extensions) for filing the tax return for the tax year the property for which the election is made is placed in service. You must attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(b)(5)) and the property items for which the election is made.

Once made, the election to use the straight-line method over the recovery period cannot be changed (see also *Alternate MACRS Method*, later).

150% election. Instead of using the declining balance method over the recovery period, you may elect to use the 150% declining balance method over the class life of the property. If the property does not have a class life assigned to it, the recovery period is 12 years. A half-year or mid-quarter convention is used, and there is a change to the straight-line method when that method will give a larger deduction. The election to use the 150% declining balance method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering "150 DB" in column (f) of Part II of Form 4562. The election must be made by the due date (including extensions) for filing the tax return for the tax year the property for which the election is made is placed in service. You must attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(b)(2)) and the property items for which the election is made.

Once made, the election to use the 150% declining balance method over the class life may not be changed.

Percentage tables. The percentage tables are based on the depreciation method, recovery period, and convention. The percentages in the tables are applied to the unadjusted basis of the property each year of the recovery period. ***Unadjusted basis*** is the same amount you would use to compute a gain on a sale not reduced for any depreciation but reduced by the amount you properly amortize or by the amount you elect to deduct under section 179. See *Conventions*, later.

The following table has the percentages for 3–, 5–, and 7–year property. The percentages are based on the 200% declining balance method and a half-year convention with a change to the straight-line method. See Publication 534 for complete tables, including tables for the mid-quarter convention.

Year	3–Year	5–Year	7–Year
1	33.33%	20%	14.29%
2	44.45%	32%	24.49%
3	14.81%	19.2%	17.49%
4	7.41%	11.52%	12.49%
5		11.52%	8.93%
6		5.76%	8.92%
7			8.93%
8			4.46%

Example. You buy for $10,000 and place in service on August 11, 1990, an item of 7–year property. You do not elect a section 179 deduction. The unadjusted basis of the property is $10,000. You use the percentages for 7–year property to figure your depreciation.

Multiply $10,000 by 14.29% to get your depreciation for 1990 of $1,429 for this item of 7–year property. For 1991, multiply $10,000 by 24.49% to get your depreciation deduction of $2,449. For later tax years you multiply $10,000 each year by the applicable 7–year percentage to get your depreciation deduction.

Computing deductions. Instead of using the percentage tables to figure depreciation, you can actually compute the depreciation deduction each year. You must apply the appropriate convention for the first year.

Declining balance method. To figure your MACRS deduction, first determine your declining balance rate of depreciation. This is determined by dividing the specified declining balance percentage (150% or 200%) by the recovery period. For example, for 3–year property, you divide 2.00 by 3 to get .6667 or 66.67%. For 15–year property, you divide 1.50 by 15 to get .10 or 10%.

Multiply the adjusted basis of the property by the declining balance rate and apply the half-year convention to figure your depreciation for the first year. In the second year, first adjust your basis for the amount of depreciation allowable for the first year. Then multiply this adjusted basis by the same rate used in the first year.

Declining balance rates. The following table shows the applicable declining balance rate for each class of property and the first year for which the straight line method will give an equal or greater deduction. For 3–, 5–, 7–, and 10–year property the rate is based on the 200% declining balance method. For 15– and 20–year property, it is based on the 150% declining balance method.

Class	Declining balance rate	Year
3	66.67%	3rd
5	40%	4th
7	28.57%	5th
10	20%	7th
15	10%	7th
20	7.5%	9th

Straight-line method. To figure your MACRS deduction under the straight-line method, a new depreciation rate is determined for each tax year in the recovery period. For any tax year, the straight-line rate is determined by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. The rate is applied to the unrecovered basis of the property. If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight-line rate for that tax year is 100%.

For example, the straight-line method applied to property with a 5–year recovery period results in a straight-line rate of 20% (1 divided by 5) for a full tax year. After applying the half-year convention, the first year rate is 10%. At the beginning of the second year, the remaining recovery period is 4.5 years as a result of the half-year convention. The straight-line rate for the second year is 22.22% (1 divided by 4.5). This second year rate is applied to the cost or other basis of the property reduced by the depreciation taken in the first year.

Conventions. Use a half-year convention to figure the deduction for property other than nonresidential real and residential rental property. Under a special rule, you may have use a mid-quarter convention. For nonresidential real and residential rental property, use a mid-month convention in all situations.

Half-year convention. Under the half-year convention, treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, on the midpoint of that tax year.

Mid-quarter convention. If during any tax year the total depreciable bases of MACRS property placed in service during the last 3 months of that tax year exceed 40% of the total depreciable bases of all MACRS property placed in service during that tax year, use a mid-quarter convention instead of a half-year convention. In determining the total bases of property, do not include the basis of:

Residential rental property,

Nonresidential real property, or

Property placed in service and disposed of in the same tax year.

Under a mid-quarter convention, treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

To figure your MACRS deduction for property subject to the mid-quarter convention, first figure your depreciation for the full tax year. Then multiply by the following percentages for the quarter of the tax year the property is placed in service.

Quarter of tax year	Percentage
First	87.5%
Second	62.5%
Third	37.5%
Fourth	12.5%

See Part II of Publication 534 for more information, including percentage tables based on the mid-quarter convention.

Mid-month convention. Under a mid-month convention, treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, on the midpoint of that month.

Alternate MACRS Method

If you choose, you may use the alternate MACRS method (also referred to as the "alternative depreciation system"). Under this method depreciation is figured using the straight-line method.

- For nonresidential real and residential rental property, the straight line method is applied to a 40–year recovery period with a mid-month convention.
- For automobiles and light general purpose trucks, it is applied over a 5–year period with a half-year or mid-quarter convention.

The alternate MACRS recovery periods for many assets can be found in the *Table of Class Lives and Recovery Periods* in Part II of Publication 534.

Election. You make the election to use the alternate MACRS method by entering the depreciation on line 15 of Part II of Form 4562. Attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(g)(7)) and the property items for which the election is made.

The election of an alternate MACRS method for one item in a property class applies to all property in that class placed in service in the tax year of the election. However, the election applies on a property by property basis for nonresidential real and residential rental property.

The election to use an alternate MACRS method once made cannot be changed.

Excluded Property

You cannot use MACRS for certain property placed in service before 1987 (before August 1, 1986, if election made) that is transferred or converted from personal to business use after 1986 (after July 31, 1986, if election made). Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance based on useful life, discussed in Part III of Publication 534. In addition, you may elect to exclude certain property from the application of MACRS.

Election to exclude certain property. If you properly depreciate any of your property under a method of depreciation that is not based on a term of years, such as the unit-of-production method, you may elect to exclude that property from MACRS. To figure a depreciation deduction under the unit-of-production method divide the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the asset. Apply the resulting amount to the units produced in a year to arrive at your depreciation for that year.

To make this election report the depreciation for the property on line 17, Part III, Form 4562, for the tax year in which your property is placed in service. Attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(f)(1)) and the property items for which the election is made.

If you use the standard mileage rate for an automobile you buy and use for business after 1980, you are considered to have elected to exclude the automobile from MACRS and ACRS. See *Standard Mileage Rate* in Publication 917, *Business Use of a Car.*

Property placed in service before 1987. These excluded property rules apply to both personal and real property; however, the rules for personal property are more restrictive. For purposes of these rules, neither real nor personal property is treated as owned before it is placed in service. Therefore, if you owned property in 1986 but do not place it in service until 1987, it is not treated as owned in 1986.

Personal property. You may not use MACRS for most personal property (section 1245 property) that you acquired after 1986 (after July 31, 1986, if MACRS was elected) if:

1) You or a party related to you owned or used the property in 1986,
2) The property was acquired from a person who owned it in 1986 and as part of the transaction the user of the property does not change,
3) You lease the property to a person (or a person related to this person) who owned or used the property in 1986, or
4) The property is acquired in a transaction in which the user of the property does not change and the property is not MACRS property in the hands of the person from whom it is so acquired due to (2) or (3).

Real property. For real property, other than nonresidential real property or residential rental property (real property with a class life of less than 27.5 years), placed in service after 1986 (after July 31, 1986, if MACRS was elected) you cannot use MACRS if:

1) You or a party related to you owned the property in 1986,
2) You lease the property back to the person (or a person related to this person) who owned the property in 1986, or
3) You acquire the property in a transaction in which some of your gain or loss is not recognized. MACRS applies only to the part of your basis in the acquired property that represents cash paid or unlike property given up. It does not apply to the substituted portion of the basis.

Related parties. For the preceding rules, a party related to you includes members of your immediate family (including your spouse, ancestors, and lineal descendants).

Special rule. The excluded property rules discussed above do not apply to any property if the allowable deduction for the property for the first tax year in which the property is in service using ACRS is greater than the deduction under MACRS using the half-year convention.

For more information on related parties and other special rules see Part II of Publication 534.

Dispositions. If you dispose of depreciable property at a profit, you may have to report, as ordinary income, all or part of the profit. See Chapter 7.

Alternative minimum tax. If you use accelerated depreciation for real property, or personal property you lease to others, you may have to attach Form 6251, *Alternative Minimum Tax—Individuals,* to your return. The alternative minimum tax applies to tax preference items. Accelerated depreciation, which is a tax preference item, is any method, including MACRS, that allows you to deduct more depreciation than you could deduct using the straight line method. For more information, see Publication 909, *Alternative Minimum Tax for Individuals.*

7. Gains and Losses

Important Changes for 1990

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged. See *Like-kind exchanges between related parties*, later.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797.

During the year, you may have sold or exchanged some business assets. The rules for correctly reporting these transactions are included in this chapter.

Sales and Exchanges

Sales and exchanges of property generally result in taxable gains or deductible losses. However, some exchanges of property are nontaxable. Exchange of property for like property is the most common type of transaction in which no gain or loss is recognized.

Sale. A sale is a transfer of property for money or for a mortgage, note, or some other promise to pay money.

Sale or purchase. If you sell property and buy similar property in two mutually dependent transactions, you may be required to treat the sale and purchase as a single nontaxable exchange.

Example. You used a pickup truck in your business for 4 years. Its depreciated basis is $500 and its trade-in value is $1,000. You are interested in a new truck that has a cash price of $10,500. Ordinarily, you would trade your old truck for the new one and pay the dealer an additional $9,500. Your basis for depreciation for the new truck is $10,000 ($9,500 cash paid plus $500 basis for the old truck). However, you arrange to sell your old truck to the dealer for $1,000 cash and buy the new truck from the same dealer for $10,500 cash. You will still be considered to have exchanged your old truck for the new one, because the sale and purchase were reciprocal and mutually dependent. Your basis for depreciation for the new truck is $10,000, the same as if you traded the old truck.

Receipt of insurance proceeds. Receipt of insurance proceeds from the destruction of your fishing boat by fire is an involuntary conversion (a casualty) and not a sale.

Exchange. An exchange is a transfer of property for other property or services, and may be taxed in the same way as a sale. However, see *Nontaxable Exchanges*, discussed later.

Involuntary exchanges (conversions). These occur when your property is destroyed, stolen, condemned, or is disposed of under threat of condemnation, and other property or money, such as insurance proceeds or a condemnation award, is received in payment.

Gain or Loss from Sales and Exchanges

Gain or loss is usually realized when property is sold or exchanged. A ***gain*** is the excess of the amount you realize from a sale or exchange of property over its adjusted basis. A ***loss*** is the excess of the adjusted basis of the property over the amount you realize.

Basis. The cost or purchase price of property is usually its basis for figuring the gain or loss from its sale or other disposition.

Adjusted basis. The adjusted basis of property is your original cost or other basis, plus certain additions, such as improvements, and minus certain deductions, such as depreciation and casualty losses. See *Adjusted Basis* in Chapter 3. In determining gain or loss, the cost of transferring property to a new owner, such as selling expenses, is added to your adjusted basis.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value of all property or services you receive. The amount you realize also includes any of your liabilities that are to be paid by the buyer, such as real estate taxes or a mortgage.

Fair market value. The price at which the property would change hands between a buyer and a seller, when both are aware of all necessary facts and neither is required to buy or sell, is the fair market value. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of fair market value. If there is a stated price for services, this price is treated as their fair market value, unless there is evidence to the contrary.

Example. In your fishing business you used a boat that you bought in 1986 for $30,000. You made certain permanent improvements at a cost of $10,000. Depreciation, under the accelerated cost recovery system (ACRS), had been deducted in the amount of $31,600. You sold the boat for $20,000 cash, plus other property having a fair market value of $2,000. The buyer assumed your note of $17,000. Your selling expenses were $1,000. Your gain on the sale is figured as follows:

Amount realized:		
Cash		$20,000
Other property (fair market value)		2,000
Note (assumed by buyer)		17,000
Amount realized		$39,000
Adjusted basis:		
Cost of boat	$30,000	
Improvements	10,000	
Total	$40,000	
Minus: Depreciation	31,600	
Adjusted basis	$ 8,400	
Plus: Selling expenses	1,000	9,400
Gain on sale		$29,600

Amount recognized. The amount you realize from a sale or exchange of business or investment property may not always be recognized (included in income) for tax purposes. Generally, gains from the sale, exchange, or other disposition of the property must be included in gross income, and losses from these transactions are deductible. However, there are exceptions to this rule, as discussed later under *Nontaxable Exchanges*.

Net operating loss (NOL). If you have a loss in the operation of your fishing business during the year, or if you had a casualty or theft loss that was more than your income, you may have a net operating loss (NOL).

An NOL is used as a deduction to reduce your taxable income in other years. You can carry it back and deduct it from income you had in an earlier year, or carry it over and deduct it from income you have in a later year. If you carry back an NOL, you must refigure your tax for the year to which you carry the NOL. If you then owe less tax than you paid for that year, you can get a refund.

Nontaxable Exchanges

Certain exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized (included in income) for tax purposes until you sell or dispose of the property you receive.

Like-kind exchanges. The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must ***meet all four*** of the following conditions:

One. The property must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither property may be used for personal purposes, such as your family car.

Two. The property must not be property held for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for use in your business and classified as a fixed asset or property held for investment. Fishing vessels, engines, radar, trucks, and rented houses are examples of property to which the rule applies.

Three. The property must be tangible property. These rules and benefits do not apply to exchanges of accounts receivable, stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, or the exchange of partnership interests.

For the rules regarding the exchange of partnership interests, see Publication 541, *Tax Information on Partnerships*.

Four. There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for personal property are exchanges of like property. For example, the trade of an apartment house for a store building, and a panel truck for a pickup truck are like-kind exchanges. The exchanges of city business property for farm business property and improved business or investment property for unimproved business or investment property are exchanges of property for like property. An exchange of personal property for real property is not an exchange of like property.

Like-kind exchanges between related parties. New rules limit whether certain exchanges made between related parties after July 10, 1989, are nontaxable. These rules affect both direct and indirect exchanges. As with other like-kind exchanges, when related parties exchange like-kind property, no gain or loss is recognized (included in income). Under the new rules, however, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss must then be recognized as of the date of disposition of the property. The two-year holding period begins on the date of the last transfer of property which was part of the like-kind exchange.

Related parties. Under these rules, a related party includes a member of your family (spouse, brother, sister, parent, child, etc.) and a corporation in which you have more than 50% ownership. For more information on related parties, see *Loss not deductible*, under *Sales and Exchanges Between Related Parties* in Publication 544.

Exceptions to the related party rules. The following kinds of property dispositions are excluded from the new limits on nontaxable like-kind exchanges between related parties:

1) Dispositions due to the death of either related person,
2) Involuntary conversions, or
3) Exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

For more information about the like-kind exchange rules, see Publication 544, *Sales and Other Dispositions of Assets.*

If you pay money. If in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible loss. See Chapter 3 to determine the basis of your new property.

Example. A fisherman trades an old fishing vessel for a new one. The new one costs $9,800. He is allowed $1,000 for the old fishing vessel and pays $8,800 cash. He has no taxable gain or deductible loss on the transaction regardless of the adjusted basis of the old vessel. If the fisherman had sold the old fishing vessel to a third party for $1,000 and then purchased a new one, he would have a recognized gain or loss on the sale of the old vessel measured by the difference between the amount realized and the adjusted basis of the old fishing vessel.

Partially nontaxable exchange. If you give up unlike property in addition to like property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and the fair market value of the unlike property.

If you receive cash. If you receive cash or unlike property in addition to like property, and the preceding conditions are met, you are taxed on the gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. Some or all of the gain may be ordinary gain attributable to depreciation, under the rules explained later. A loss is never deductible in a nontaxable exchange, even though you receive cash or unlike property. The basis of your new property is discussed in Chapter 3.

Example. You exchange real estate you held for investment that has an adjusted basis of $8,000, for other real estate to be held for investment. The real estate you receive has a fair market value of $10,000. You also receive $1,000 in cash. Although the total gain realized on the transaction is $3,000, only $1,000 (cash) is recognized and included in your income.

Assumption of liabilities. Assumption of liabilities by the other party or a transfer of property subject to a liability is treated as the receipt of cash. If, in the preceding example, that the property you transfer is subject to a $3,000 mortgage. Then figure the gain realized and the amount of gain to be taxed as follows:

Fair market value of like property received	$10,000
Cash	1,000
Mortgage assumed on property given up	3,000
Total received	$14,000
Less: Adjusted basis of property you transferred	8,000
Realized gain	$ 6,000

The realized gain is taxed only to the extent of $4,000, the sum of the money ($1,000) and the mortgage ($3,000).

Reporting the exchange. Report the exchange of like-kind property on Schedule D (Form 1040) or on Form 4797, whichever applies. The instructions for each form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797.

Transfers between spouses. No gain or loss is recognized (included in taxable income) on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. For more information, see *No gain or loss* under *Property Settlements* in Publication 504, *Tax Information for Divorced or Separated Individuals.*

Related Parties

If a gain is recognized on the sale or exchange of property, including a leasehold, that is depreciable property in the hands of the party who receives it, the gain may be ordinary income. The gain is ordinary income if the transaction is either directly or indirectly between:

1) A person and that person's controlled entity or entities (discussed below),
2) A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary, unless the beneficiary's interest in the trust is a remote contingent interest that is, the value of such interest computed actuarially is 5% or less of the value of the trust property, and
3) An employer and any person related to the employer under rules (1) and (2).

A controlled entity is:

1) A corporation in which more than 50% of the value of all outstanding stock, or a partnership in which more than 50% of the capital interest or profits interest, is owned by or for one person.
2) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.
3) Two corporations that are members of the same controlled group.
4) Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
5) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

Loss not deductible. No loss deduction is allowable if the transaction is directly or indirectly between certain related parties. Among such parties are included members of the same immediate family, meaning brothers and sisters (whether by whole or half blood), husband and wife, ancestors, and lineal descendants. See *Loss not deductible* under *Sales and Exchanges Between Related Parties* in Publication 544.

Property received from related party. If, in a sale or exchange, you receive property from a related party who had a loss on the exchange that was not allowable and you sell or exchange the property at a gain, you recognize gain only to the extent that it exceeds the amount of the loss previously disallowed to the transferor. This rule applies only to the original transferee.

Example. You (the transferor) sell stock with a cost basis of $10,000 to your brother (the transferee) for $7,600. The loss of $2,400 is not deductible. Later he sells the same stock for $10,500, thus realizing a gain of $2,900 ($10,500 −$7,600). His reportable gain is only $500, the excess gain over the $2,400 loss not allowed to you.

Ordinary or Capital Gain or Loss

If you have a taxable gain or a deductible loss from a sale or exchange of property, it may be either an ordinary gain or loss, or a capital gain or loss, or a combination of both. Usually, the full amount of an ordinary gain is taxable, and the full amount of an ordinary loss is deductible. The amount of a capital gain or loss that can be taxed or deducted depends upon whether the gain or loss is short- or long-term.

Holding period. You have a long-term capital gain or loss if you have held the asset for more than one year before you dispose of it. You have a short-term capital gain or loss if you have held the asset for one year or less before you dispose of it.

Tax treatment. You must still distinguish gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions are essential to correctly arrive at your net capital gain or loss and figure the limit on capital losses. See Chapter 9.

Types of assets. The main factor that determines whether a gain or loss is capital or ordinary is the type of asset you sold or exchanged. The sale or exchange of certain assets results in a capital gain or loss, while the sale or exchange of other assets results in ordinary gain or loss. It is also possible to have a sale or exchange of an asset on which part of your gain or loss may be ordinary and part may be capital.

As you can see, it is important to know what type of asset you have disposed of as well as how long you have owned it.

All tangible or intangible property (see Chapter 3, *Business Assets*) that you own is classified as:

1) A capital asset,
2) A noncapital asset, or
3) An asset that may be treated as either capital or noncapital, depending upon circumstances explained in Chapter 9. This classification includes most assets used in a trade or business and involuntarily converted assets.

Capital assets. All items you own and use for personal, pleasure, or investment purposes are capital assets. Also, an intangible property right may be a capital asset. Following are some examples of capital assets:

1) A dwelling owned and occupied by you and your family.
2) Household furnishings used by you and your family.
3) An automobile used for pleasure (If your automobile is used both for pleasure and for business, it is partly a capital asset and partly a noncapital asset, as defined later).
4) Stocks and bonds when held by individuals for investment. You will find additional information on this subject in Publication 550, *Investment Income and Expenses.*

Personal casualty gains and losses. To figure your personal casualty (or theft) loss, reduce each loss by $100. If your personal casualty gains for the tax year exceed your personal casualty losses, all of your personal casualty gains and losses are treated as sales and exchanges of capital assets. If your personal casualty losses for the tax year exceed your personal casualty gains, losses to the extent of gains can be deducted in full. Losses in excess of gains are deductible on Schedule A to the extent they exceed 10% of your adjusted gross income. Use Section A of Form 4684, *Casualties and Thefts,* to report all personal casualty gains and losses. For more information, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Noncapital assets. An asset is a noncapital asset if it is excluded from the definition of capital assets. A list of properties, excluded from the definition of capital assets, appears in the Schedule D (Form 1040) instructions.

Property held for sale in the ordinary course of your fishing business. Property you hold mainly for sale such as fish, lobsters, and crabs, are noncapital assets. Gain or loss from sales or other dispositions of such property is reported on Schedule C (Form 1040) and not on Form 4797, *Sales of Business Property.*

Business assets. Business assets classified as real property used in your trade or business are noncapital assets, but may be treated as such under certain circumstances. As explained under *Property used in fishing,* your gains and losses from sales and exchanges of depreciable properties are considered together with certain other transactions to determine whether the gains and losses are treated as capital or ordinary gains and losses.

Property used in fishing. The following types of property are subject to special rules when disposed of:

Property used in your fishing business or for the production of rents or royalties and held over one year, and

Any property held over one year that is involuntarily converted.

A gain or loss on the sale, exchange, or involuntary conversion of such property may be a capital gain or loss, or an ordinary gain or loss. Also, unlike the sale of your personal residence, if you sell your fishing vessel you must recognize any gain in the year it is sold, even if you buy a vessel to replace it. But see the earlier discussion of *Nontaxable Exchanges.*

Sales or exchanges of the following properties used in your business and held more than one year may result in ordinary or capital gain or loss:

1) Depreciable property used in your business, such as a fishing vessel, refrigeration equipment, or a truck.
2) Real estate used in your business, such as your gear shed or net loft.
3) Property held for the production of rents or royalties.
4) Involuntary conversions of business property and capital assets held in connection with a trade or business or a transaction entered into for profit, held for more than one year resulting from casualties and thefts (whether insured or uninsured). These include casualty or theft to business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance payments or other reimbursement must be taken into account in arriving at the net gain or loss. However, if your net losses from casualty or theft exceed gains from casualty or theft, they are not taken into account in the section 1231 computation. See *Personal casualty gains and losses,* earlier. Also see Publication 547.

Section 1231 property. The above types of property are referred to as "section 1231 property." You combine all the gains and losses from section 1231 property for the tax year. Your excess section 1231 gains over your section 1231 losses is a net section 1231 gain. Your excess section 1231 losses over section 1231 gains results in a net section 1231 loss.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent the gain does not exceed nonrecaptured net section 1231 losses. ***Nonrecaptured losses*** are net section 1231 losses deducted in tax years beginning after 1981 that have not yet been applied (recaptured) against any net section 1231 gains in a tax year beginning after 1984. Your losses are recaptured beginning with the earliest year subject to recapture.

Casualty and thefts. If your recognized losses from involuntary conversions arising from fire, storm, shipwreck, other casualty, or theft exceed your recognized gains from such conversions, they are included in figuring your net section 1231 gains or losses to figure recapture of net section 1231 losses.

Long-term capital gain or ordinary income? If you did not have any prior year net section 1231 losses or they were recaptured in an earlier year, treat your net section 1231 gain for 1990 as long-term capital gain.

If you had such losses and they were not recaptured, your net section 1231 gain is treated as ordinary income up to the amount of your nonrecaptured losses. If the gain exceeds your losses, the excess is a long-term capital gain.

A net section 1231 loss. For 1990, this is treated as an ordinary loss.

Form 4797. Section 1231 gains and losses are figured on Form 4797. See Chapter 9 for more information on section 1231 property.

Gain on Disposition of Depreciable Property

Depreciation that you have taken on property may cause you to have to treat a gain on the disposition of depreciable real or personal property as ordinary income.

This applies if you figured depreciation using a method, that produces a greater depreciation deduction than that produced by the straight-line method, or you have recapture of the section 179 deduction.

Generally, after 1986, additional depreciation is not treated as ordinary income on the disposition of residential rental property or nonresidential real property because these properties are now depreciated using the straight line method. For more information about the rules covering depreciation of business assets, see Chapter 6. See *Depreciation Recapture on Personal Property* and *Depreciation Recapture on Real Property* in Publication 544 for more information about disposing of such properties.

Reporting gain. Gain from the sale, exchange, involuntary conversion, or other disposition of depreciable personal property, including a sale and leaseback transaction, is figured in Part III of Form 4797. This gain may be ordinary income or a combination of ordinary income and capital gain income (see Chapter 9).

Depreciation. Depreciation is the amount allowed or allowable for section 1245 property for cost recovery of property used in a trade or business or held for the production of income.

Section 179 deduction. Amounts deducted under section 179 are recovered as ordinary income to the extent of any gain on a sale or disposition. The section 179 deduction is treated as a deduction for amortization and is included in the recomputed basis. See Chapter 6.

Investment credit. On a disposition of property on which you took the investment credit, the reduction in basis by part or all of the credit claimed is considered a deduction allowed for depreciation.

If a disposition results in the recapture of investment credit on property for which the depreciable basis has been reduced, the basis of the property immediately before the disposition resulting in the recapture is increased by part or all of the recapture amount. This amount is any increase in tax that must be paid plus any adjustment to investment credit carrybacks or carryforwards. For information on the recapture of investment credit, see Form 4255.

Section 1245 property with a carryover basis. If the section 1245 property you dispose of at a gain had a carryover basis, the recomputed basis of that property includes depreciation or amortization taken on the property you exchange. This amount is reduced by any gain you recognized on the exchange. Carryover basis property for this purpose is property you received in a like-kind exchange or an involuntary conversion.

Depreciation allowed or allowable. The greater of depreciation allowed or allowable is generally the amount to use in figuring the part of the gain to report as ordinary income. If in prior years you have consistently taken proper deductions under one method, the amount allowable for your prior years will not be increased even though a greater amount would have been allowable under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method of depreciation.

This treatment applies only when figuring what part of the gain is treated as ordinary income under these rules.

Gifts. If you make a gift of depreciable personal property, you are not required to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property and this subsequent disposition is subject to recapture, the donee must take into account the depreciation that you deducted in figuring the gain to be reported as ordinary income.

Disposition part gift and part sale or exchange. If you transfer depreciable personal property or real property for less than its fair market value, in a transaction considered to be partly a gift and partly a sale or exchange, and you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain) to recapture depreciation. If the depreciation is more than the gain, the balance of your depreciation is carried over to the transferee, to be taken into account on any later disposition of the property.

Example. You transfer your fishing boat to your son for $20,000. The boat had an adjusted basis to you of $10,000 and a fair market value of $40,000, and your depreciation was $30,000. You are considered to have made a gift of $20,000, the difference between the $40,000 fair market value and the $20,000 sales price to your son. You have a taxable gain on the transfer of $10,000 ($20,000 sale price minus $10,000 adjusted basis) that must be reported as ordinary income because of depreciation. Since you report $10,000 of your $30,000 depreciation as ordinary income on the transfer of the boat, only the remaining $20,000 is carried over to your son and is to be taken into account by him on any later disposition of the property.

Transfers at death. When a taxpayer dies, no gain is reported on depreciable personal property or real property that is transferred to the taxpayer's estate or beneficiary. For more information, see Publication 551.

If the taxpayer disposed of the property before death and, because of the method of accounting or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported the same way the decedent would have been required to report it if he or she were alive.

Example. Jim Smith owns a fishing boat that, upon his death, is inherited by his son. No ordinary income, because of depreciation, is reportable on the transfer, even though the value used for estate tax purposes is more than the adjusted basis of the boat to Jim when he died. However, if Jim had sold the boat before his death and realized a gain, and if because of his method of accounting, the proceeds from the sale were income in respect of a decedent reportable by his

son, he would have to report ordinary income because of depreciation.

Like-kind exchanges or involuntary conversions. A like-kind exchange of your depreciable personal property, or an involuntary conversion of the property will not result in your having to report ordinary income because of depreciation unless property other than depreciable personal property is received in the transaction.

If you receive property other than depreciable personal property and you include gain as ordinary income because of depreciation, the amount is limited to the ***smaller*** of:

1) The gain on the transaction up to the amount of depreciation deducted, or
2) The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions, ***plus*** the fair market value of property other than depreciable personal property acquired in the transaction.

Example 1. On January 4, 1990, you bought new equipment for your boat for $4,300 cash plus your old equipment for which you were allowed a $1,360 trade-in. The old equipment cost you $5,000 on January 2, 1986. For 1986 through 1989, you take ACRS deductions of $750, $1,100, $1,050, and $1,050. Even though $3,950 has been deducted under ACRS, the $310 gain ($1,360 trade-in allowance minus $1,050 adjusted basis) need not be reported because any tax on the gain is postponed and you received only depreciable personal property in the exchange.

Example 2. On January 4, 1988, you bought equipment for your boat for $1,500. You deducted $300 and $480 under MACRS on your 1988 and 1989 returns. On January 3, 1990, a fire destroyed the equipment and you received $1,200 from your fire insurance. However, replacement equipment cost you only $1,000. Your taxable gain is limited to the remaining $200 insurance payment. Because your taxable gain is less than the $780 ACRS deduction you claimed, the $200 is reported as ordinary income.

Records. You must keep permanent records of the facts necessary to figure the depreciation allowed or allowable on your depreciable property in order to figure the gain to be reported as ordinary income. In general, the information needed will be the same as that required for other tax purposes including the dates of acquisition, cost or other basis, depreciation, and all other adjustments that affect basis.

On property that you got in a nontaxable exchange or as a gift, your records must also indicate the following:

1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property, and
2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Form 4797. Form 4797, discussed in Chapter 9, is used to report the gain or loss from the preceding transactions.

8. Casualty and Theft Losses

When property is damaged or destroyed by hurricane, earthquake, tornado, fire, vandalism, auto, truck, or boat accident, flood, etc., such an event is called a ***casualty.*** A casualty may result in a deductible loss on your federal income tax return. If your property is stolen, you may have a deductible ***theft*** loss.

The lawful taking of your property, without your consent, for public use by the federal government, a state government, or a political subdivision is a ***condemnation*** that can result in a gain or a loss.

Casualties, thefts, and condemnations are called ***involuntary conversions.*** For more information on condemnations, see Publication 544, *Sales and Other Dispositions of Assets.*

Casualty

A casualty loss must result from an identifiable event that is sudden, unexpected, or unusual. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and unintentional on the part of the one who has the loss. An unusual event is one that is not a day-to-day occurrence and one that is not typical of the activity in which you were engaged.

For information on casualties and thefts of nonbusiness property, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Deductible casualty losses. Deductible casualty losses may result from a number of different causes, including:

1) Earthquakes, hurricanes, tornadoes, floods, storms, volcanic eruptions, shipwrecks, mine cave-ins, sonic booms, and vandalism.
2) Fires, but if you set the fire, you cannot deduct the loss resulting from the fire.
3) Car or boat accidents, but if your willful negligence or willful act caused the accident, or it was caused by the willful act or willful negligence of someone acting for you, the loss to your car or boat is not a casualty loss.

Nondeductible losses. Damage from a normal process or from ***progressive deterioration*** through a steadily operating cause, such as the steady weakening of a building from wind and weather or the infestation of termites, is not a casualty.

Related expenses. Expenses such as the care of personal injuries and the rental of equipment are not deductible as part of the casualty loss. However, if you have these expenses in connection with a casualty loss to your business property, you may be able to deduct them as business expenses.

Theft

A theft is the unlawful taking and removing of your money or property with the intent to deprive you of it. Theft includes, but is not limited to, larceny, robbery, and embezzlement. Extortion, kidnaping, threats, or blackmail may be thefts. You must be able to show that the taking of your property was illegal under the law of the state where it occurred, and that it was done with criminal intent.

Misiaid or lost property. The mere disappearance of money or property in itself is not a theft. However, an accidental loss or disappearance of property may qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was actually a casualty or theft, and you must be able to support the amount you take as a deduction.

For a ***casualty,*** you should be able to show:

1) The type of casualty (car or boat accident, fire, storm, etc.) and when it occurred,
2) That the loss was the direct result of the casualty, and
3) That you were the owner of the property, or, if you leased the property from someone else, that you were liable, under a contract to the owner for the damage.

For a ***theft,*** you should be able to show:

1) When you found that your property was missing,
2) That your property was actually stolen, and
3) That you were the owner of the property.

How To Figure a Loss

If you have a loss to business or income-producing property, you must figure your loss separately for each item that is stolen, damaged, or destroyed.

Total loss of business property. If your business property is completely destroyed, your deductible loss is the adjusted basis of the property minus any salvage value and any insurance or other reimbursement you receive or expect to receive. For example, if you claimed the cost of wet gear as a business expense for the year of purchase rather than capitalizing its cost and claiming depreciation, you have no adjusted basis and thus no deductible loss.

You have a loss if the amount you receive is less than the adjusted basis of the property. Except for a casualty or theft, if your loss is from property you held for personal use, you cannot deduct it. You should report any deductible loss in the tax year in which it happened.

For a casualty, you have a loss if the amount you receive is the decrease in the property's fair market value or the adjusted basis, whichever is less. You figure gain or loss on the total destruction of business property by comparing the amount of reimbursement received with the adjusted basis of the property, without taking into account fair market value.

Amount received. The amount you receive includes the money plus the fair market value of unlike property you receive in exchange for the damaged, destroyed, or stolen property minus your expenses in obtaining them. For casualties or thefts, it also includes any insurance or other reimbursement you receive or expect to receive.

Stolen business property. If your business property is stolen, your deductible loss is your adjusted basis in your property, reduced by any insurance or other reimbursement you receive or expect to receive.

Partial loss of business property. If your business property is only partly destroyed, your loss is the decrease in the fair market value of the property due to the casualty or theft, or the adjusted basis of the property, whichever is less. From this amount you must subtract any insurance or other reimbursement you receive or expect to receive.

Figure each casualty separately. You must figure separately each individual property damaged or destroyed. For example, if casualty damage occurs to both your storage shed and dock, the loss is measured separately for the shed and the dock.

Decrease in fair market value. To figure the decrease in fair market value because of a casualty or theft, you must determine the fair market value of your property immediately before and after the loss. The decrease is the difference between the value of the property immediately before and immediately after the casualty. ***Fair***

market value is defined in Chapter 3. These values should be determined by competent appraisers. You may not deduct the cost of repairing, replacing, or cleaning up after the casualty unless it is a business expense.

Example 1. You owned a fishing boat used in your business. The boat had an adjusted basis of $30,000 when it was partly destroyed by a storm. The value immediately before the storm was $60,000 and the value immediately after was $40,000. The decrease in the fair market value is $20,000 ($60,000 minus $40,000). Since this is less than the adjusted basis, $30,000, your deductible loss is $20,000 minus any insurance or other reimbursement you receive or expect to receive.

Example 2. If, in Example 1, the value of the boat after the storm had been only $25,000, the adjusted basis, $30,000, would have been less than the value of the destroyed part ($60,000 minus $25,000, or $35,000). In this case, your deductible loss would be $30,000 minus any insurance or other reimbursement you receive or expect to receive.

Repair cost. The cost of cleaning up or of making repairs after a casualty may be used as a measure of the decrease in fair market value if:

1) The repair cost is needed to bring the property back to its condition before the casualty,
2) The cost of repairs is not excessive,
3) The repairs do no more than take care of the damage, and
4) The value of the property after repairs is not, as a result of the repairs, more than its value before the casualty.

Appraisals. Appraisal should be made by an experienced and reliable appraiser. The appraiser's knowledge of sales of comparable property and familiarity with your property before and after the casualty, and the method used to determine the amount of the loss are important elements for proving a casualty loss.

Cars. The books issued by various automobile organizations are useful in figuring the value of your car. You can use the wholesale or trade-in value given in these books, and modify that for such factors as the mileage and condition of your car. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Basis of property damaged. The basis of property damaged or destroyed by a casualty is reduced by the allowable casualty loss deduction. You must further reduce the basis by any insurance or other reimbursement you receive.

Example. Your business truck is involved in an accident. After appraisals have been made, you determine the loss to be $2,000. You carry $250 deductible insurance. You receive $1,750 from the insurance company. Your deductible casualty loss is $250 ($2,000 minus $1,750 insurance). The basis of your truck must be reduced by your casualty loss, $250, and further reduced by the $1,750 of insurance received.

When to deduct losses. Generally, you may deduct casualty losses only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year. If you are liable for casualty damage to leased property, you deduct your loss in the year the liability becomes fixed, not the year it is paid. The lessee is not entitled to a loss deduction until liability under the lease is ascertainable with reasonable accuracy.

Theft losses are generally deductible only in the year you discover them. You must prove that there was a theft, and identify the year you discovered the property was stolen. You do not have to prove when it was stolen.

Disaster area losses. If you have a deductible loss due to a disaster that occurred in an area determined by the President of the United States to be eligible for federal disaster assistance, you may choose to deduct that loss on your return for the immediately ***preceding tax year.*** If you make this choice, the loss will be considered as having occurred in the preceding year.

Insurance and other reimbursement. You may deduct only the part of a casualty or theft loss that is not covered by insurance or other reimbursement. If you made a claim for reimbursement, the part of the loss covered by the claim is not deductible. But, if you determine with reasonable certainty that you will not receive all or part of the claim, the amount you will not receive may be deducted for that year.

Example 1. In 1989, as the result of negligence of the other driver, your business truck, having a fair market value of $4,000 and an adjusted basis of $3,000, was completely destroyed in a collision with another truck. As of December 31, 1989, there was reasonable prospect that you would recover the total damages from the owner of the other truck. You do not have a deductible loss in 1989. In January 1990, the court awards you a judgment of $4,000. In July 1990, you can show with reasonable certainty that you cannot collect from the other driver. You may claim a $3,000 loss in 1990.

Example 2. Your fishing boat, with an adjusted basis of $25,000, was completely destroyed by fire in 1989. Your only claim for reimbursement was an insurance claim for $18,000. You may claim a casualty loss deduction of $7,000 in 1989 because the most you could possibly have collected from your claim was $18,000. In 1990 the insurance company offered to settle your claim for $15,000 and you accepted the offer. In 1990 you may claim an additional deduction of $3,000, the excess of your total loss of $10,000 ($25,000 minus $15,000) over the amount claimed in 1989 ($7,000).

Lump-sum reimbursements. If you have a casualty or theft loss of several assets at the same time and you receive a lump-sum reimbursement, you must divide the lump-sum reimbursement among the assets according to the fair market value of each of the assets at the time of the loss. You must make a separate computation of the gain or loss for each asset that has a separate basis.

Reimbursement in a later year. If you receive reimbursement in a later year for a loss that you already had deducted, you must include the reimbursement in income to the extent the deduction reduced your tax in the earlier year. You do not refigure the tax for the year you claimed the deduction.

Use and occupancy insurance. If insurance reimburses you for your loss of business income, it does not reduce your casualty or theft loss. However, the insurance reimbursement is income and is taxed in the same manner as your business income.

Reporting. Use Form 4684, *Casualties and Thefts,* to report gains and losses from casualties and thefts. On Form 4684, you must list each item or article for which you are claiming a casualty or theft loss.

Postponement of Gain

You have a gain on a casualty or a theft if the amount you receive is more than the adjusted basis of the damaged, destroyed, or stolen property. You may postpone reporting the gain.

You must ordinarily report the gain on your damaged, destroyed, or stolen property if you receive money or unlike property as reimbursement. However, you can choose to postpone reporting the gain if, within a specific period of time, you acquire qualified replacement property, discussed later. The replacement property must be similar or related in service or use to the damaged, destroyed, or stolen property. You may also postpone the gain if you spend the reimbursement to restore the property.

If you are a member of a partnership or a shareholder in a corporation that owns the damaged, destroyed, or stolen property, only the partnership or corporation, and not you, can choose to postpone reporting the gain.

To postpone all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

Example. A fishing boat used in your business, having an adjusted basis of $9,000, was totally destroyed by fire. During that year, you received $11,000 from the insurance company and immediately spent $9,500 to replace the destroyed boat. You realized a gain of $2,000 from the destruction of the old boat. Since $1,500 of the insurance reimbursement was not spent for its replacement, you must report $1,500 in your gross income. You may choose not to report the other $500 of gain. If you had spent only $8,500, you would have been required to report the entire gain of $2,000.

Replacement property. You must buy replacement property for the specific purpose of replacing your damaged, destroyed, or stolen property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the actual reimbursement from your old property to acquire the replacement property. Property you acquire by gift or inheritance does not qualify as replacement property.

Advance payment. If you pay a contractor in advance to build your replacement property, you are not considered to have bought replacement property unless the building of the replacement property is finished before the end of the replacement period.

Similar or related in service or use for an owner-user. If you are an owner-user, similar or related in service or use means that the replacement property must function the same as the property it replaces. An example of replacement property that is similar or related in service is a business vehicle that replaces another business vehicle and is used by the business in the same way.

Substituting replacement property. Once you have acquired replacement property that you designate as replacement property, you may not later substitute other qualified replacement property. This is true even if you do it within the replacement period. The designation is made by the statement with your return reporting that you have acquired replacement property. However, if after you replace the property you discover that it was not qualified replacement property, you may, within the replacement period, substitute the new qualified replacement property.

Replacement period. To postpone reporting your gain, you must buy replacement property within the replacement period.

The ***replacement period begins*** on the date your property was damaged, destroyed, or stolen.

The ***replacement period ends*** 2 years after the close of the first tax year in which any part of your gain is realized.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. Your application should contain all the details about the need for the extension. You should apply before the end of the replacement period. However, you may file an application within

a reasonable time after the replacement period ends if you can show a good reason for the delay. An extension of time will be granted if you can show reasonable cause for not making the replacement within the regular period.

How to postpone a gain. You should report your choice to postpone your gain from a casualty or theft on your tax return for the year in which you had the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year in which gain is realized, you must attach a statement to your return. The statement should show the amount realized, how you figured the gain, and the amount of any gain you are reporting as income.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year in which you have the gain, you must attach a statement to your return. The statement should say that you are choosing to replace the property within the required replacement period.

You then attach another statement to your return for the year in which you buy the replacement property. This statement should contain detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must make a statement for each year. The statement should contain detailed information on the replacement property bought in that year.

Amended return. You must file an amended return for the tax year in which you made the election if:

1) You either did not acquire replacement property within the required replacement period,
2) You buy replacement property within the required replacement period but at a cost less than the amount you expected when you made the election, or
3) You decided not to replace the property.

Changing your mind. You may change your mind about whether to report or postpone your gain at any time before the end of the replacement period. However, see *Substituting replacement property,* earlier.

Example. Your property was destroyed by fire, and you had a gain of $5,000. You reported the gain on your return for the year you received it, and paid the tax that was due. You buy replacement property within the replacement period. You used all but $1,000 of your gain to buy the replacement property. You wish to change your election to postpone the tax on the $4,000 of gain spent for the replacement property.

You should file a claim for refund on Form 1040X, *Amended U.S. Individual Income Tax Return.* Attach an explanation to your Form 1040X showing that you previously reported the entire gain from the fire but you now want to change your election and report only the part of the gain ($1,000) not spent for replacement property.

9. Reporting Gains and Losses

Important Change for 1990

New Form 8824. Beginning in 1990, if you have a like-kind exchange, you must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797.

This chapter discusses the reporting of capital gains and losses and ordinary gains and losses from sales, exchanges, and other dispositions of property. It covers the use of Schedule D (Form 1040), Form 4684, and Form 4797.

Schedule D

Capital gains and losses and the exchange of like-kind property are reported on Schedule D (Form 1040). This schedule is also used to figure capital gains and the limit on capital losses, both of which are explained in this chapter. Line references in this section are to Schedule D (Form 1040).

Any net section 1231 gain from Part I of Form 4797 is reported as a long-term capital gain on Schedule D (Form 1040). This amount is any net gain resulting from sales, exchanges, and involuntary conversions of real or depreciable property used in your trade or business, or held for the production of rents or royalties. Also, the net section 1231 gain from Part I of Form 4797 includes involuntary conversions of capital assets held for more than one year in connection with a trade or business or a transaction entered into for profit. Form 4797 is discussed later in this chapter.

New Form 8824. Beginning in 1990, you must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797 when you exchange property in a like-kind transaction.

Form 1099–B If you sold stocks, bonds, commodities, etc., you should receive Form 1099–B or an equivalent statement from your broker. Use Form 1099–B or equivalent statement to fill out line 1 of Schedule D (Form 1040).

Whether or not you receive Form 1099–B, you must report all taxable sales of stocks, bonds, commodities, etc., on Schedule D. For more information about figuring gains and losses from these transactions, see Publication 550, *Investment Income and Expenses.*

Short-term gains and losses. A gain or loss on the sale or exchange of a capital asset held one year or less is a short-term capital gain or loss. Report it in Part I.

Gain. Gain on the sale or exchange of property held for personal use (such as your residence) and held for one year or less is a short-term capital gain. Report it in Part I. Losses on sales or exchanges of property held for personal use are not deductible.

Combine your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries, with any short-term capital loss carryover, and your other short-term gains and losses to figure net short-term capital gain or loss.

Long-term gains and losses. Gain or loss on the sale or exchange of a capital asset held more than one year is a long-term capital gain or loss. Report it in Part II.

Gain. Gain on the sale or exchange of property held for personal use and held more than one year is a long-term capital gain. Report it in Part II. Loss on the sale or exchange of property held for personal use is not deductible.

Net long-term gain or loss. Net section 1231 gain from Part I of Form 4797, after reduction for prior years net section 1231 losses, if applicable, is a long-term capital gain. See Chapter 7. Report this gain in Part II of Schedule D (Form 1040). The following are also reported in Part II:

1) Capital gain distributions from regulated investment companies, mutual funds, and real estate investment trusts,
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
3) Long-term capital loss carryovers, and
4) Your capital gain distributions, unless you do not need to report any other capital gains or losses.

The result of combining these items with your other long-term gains and losses is your net long-term capital gain or loss.

Total net gain or loss. You figure your total net gain or loss by combining your net short-term capital gain or loss with your net long-term capital gain or loss. Enter the result on line 18, Part III. If losses are more than gains, see the following discussion on *Treatment of capital losses.*

Treatment of capital losses. If you have a net capital loss, you must deduct it even if you do not have ordinary income to offset the loss. The yearly limit on the amount of the capital loss you are required to deduct is the lower of:

- $3,000 ($1,500 if you are married and file a separate return), or
- Your net capital loss on line 18 of Schedule D (Form 1040).

If you only have long-term gains and losses, your allowable loss, in 1990, is also the same as your net long-term capital loss. If you have both short-term and long-term items, figure the amount of your allowable loss as follows:

1) If you have a net short-term capital loss and a net long-term capital gain, your short-term capital loss is the excess of the loss over the gain.
2) If you have a net long-term capital loss and a net short-term capital gain, your long-term capital loss is the excess of the loss over the gain.
3) If you have both a net short-term capital loss and a net long-term capital loss, your allowable net capital loss is the total of the short-term loss plus the total of the long-term loss.

Example 1. You have capital gains and losses for the year as follows:

	Short-term	Long-term
Gains	$700	$ 400
Losses	$800	$2,000

Your total net capital loss is $1,700, which is figured as follows:

Short-term capital losses	$ 800	
Minus: Short-term capital gains	700	
Net short-term capital loss		$ 100
Long-term capital losses	$2,000	
Minus: Long-term capital gains	400	
Net long-term capital loss		$1,600
Total net capital loss		$1,700

Example 2. You have a net long-term capital loss of $1,600 and a net short-term capital gain of $450. Your total net capital loss is $1,150 ($1,600 −$450).

Capital loss carryover. If your net capital loss is more than the yearly limit on capital loss deductions, carry over the excess to later years until it is completely used up. When you carry over a loss, it retains its original character as either long term or short term. A short-term loss that you carry over to the next tax year is added to short-term losses that occur in that year. A long-term loss that you carry over is added to long-term losses that occur in that year.

For more information about the treatment of capital losses, see *Treatment of Capital Losses* in Publication 544, *Sales and Other Dispositions of Assets.*

Joint and separate returns. On a joint return, the capital gains and losses of a husband and wife are figured as though they are the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to $1,500 (one-half of the $3,000 limit allowed on a joint return). Neither you nor your spouse may deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, you and your spouse must combine each of your capital loss carryovers. However, if you and your spouse once filed jointly and are now filing separately, any capital loss carryover can be deducted only on the return of the person who actually had the loss.

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The capital loss limits discussed earlier still apply in this situation. Even if the loss is greater than the limit, the excess cannot be deducted by the decedent's estate or carried over to following years.

Form 4797

A sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties sometimes results in a capital gain or loss or an ordinary gain or loss. All or part of any gain from the disposition of such property may be ordinary gain attributable to depreciation, discussed in Chapter 7.

Gains and losses from involuntary conversions of capital assets held for more than one year, in connection with a transaction entered into for profit, may also be treated as capital or ordinary gains and losses, depending on the circumstances.

Form 4797 is used to report these transactions and to determine the amount of ordinary or capital gain or loss.

Condemnations. Gains and losses from condemnations of capital assets held one year or less are short-term capital gains or losses reportable in Part I, Schedule D (Form 1040) unless they are losses on property held for personal use, which are nondeductible.

Real estate transactions. Information reporting must be provided on certain real estate transactions. For closings in 1990, generally the person responsible for closing the transaction must report to IRS on the Form 1099-S, *Statement for Recipients of Proceeds From Real Estate Transactions.* He or she is required to indicate on the form, the sale or exchange of a single-family residence, a multi-family residence having four or fewer units, or stock in a cooperative housing corporation.

If you have sold or exchanged the above type of property, the reporting person must give you a copy of the Form 1099-S or a statement containing the same information. Use Form 1099-S to fill in the gross proceeds requested on line 1 of Form 4797, or the form you are using to report the sale or exchange.

Note. If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting is not required to value that property or those services. In that case, the gross proceeds reported on Form 1099-S will be less than the sales price of the property you sold. After you include the gross proceeds amount on line 1 of Form 4797, figure any gain or loss according to the sales price, which is the total amount you realized on the transaction.

New Form 8824. Beginning in 1990, you must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797 when you exchange property in a like-kind transaction.

Form 4684

A casualty or theft loss of business property or property used in a transaction entered into for profit is always deductible.

Form 4684. Use Form 4684, *Casualties and Thefts* to figure and report casualty and theft losses and gains. Section B, Part I, has space to figure a gain or loss on four items of business property. List each item or article for which you are claiming a casualty or theft loss. If more than four items of property were damaged or stolen in a single casualty or theft, complete Section B, Part I, of additional Forms 4684, or substitute your own statement for Section B, Part I. The statement must include the same information that is asked for in Section B, Part I.

If you had more than one casualty or theft during the year, use a separate Section B, Part I of Form 4684, for each casualty or theft.

Section B, Part II of Form 4684, is used to summarize all your gains and losses from casualties and thefts of trade or business or income-producing property during the tax year. The summarized information is then carried to other tax forms. Short-term gains and losses are listed separately from long-term gains and losses. Part II also divides losses by the type of property. Losses on business property and property that earns rent or royalty income are listed in column (b)(i). Losses on income-producing property are listed in column (b)(ii). Gains are listed in column (c).

10. Self-Employment Tax

Important Changes for 1990

Maximum earnings for self-employment tax. The maximum amount of net earnings subject to the self-employment tax for 1990 is $51,300.

Tax rate for self-employment tax. The self-employment tax rate for 1990 is 15.3%, and the 2% credit for 1989 has been replaced by two deductions. See *Tax rates* under *Figuring the Tax.*

The self-employment tax is a social security tax for individuals who work for themselves. It is similar to the social security tax withheld from the pay of wage earners.

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits and with medical insurance benefits (Medicare). For an explanation of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Social security coverage. In 1990, you will receive a quarter of social security coverage, up to four quarters, for each $520 of self-employment income subject to the self-employment tax.

Social security number. You must have a social security number to pay the self-employment tax. If you do not have a number, see *Application for identification number* in Chapter 1.

Who Must Pay the Tax

If you carry on a ***trade or business*** as a sole proprietor, a member of a partnership, or as an independent contractor, you probably have to pay self-employment tax on your self-employment income.

Fishing crew members. If you are a crew member on a boat that is engaged in the catching of fish or other forms of water life, you may have to pay self-employment tax. See the discussion on *Certain Crew Members Considered Self-Employed* in Chapter 11.

Income limits. You must pay self-employment tax if you have net earnings from self-employment of $400 or more. You must also pay self-employment tax if you are paid $100 or more in a year as an employee of a church or qualified church-controlled organization that elected exemption from social security taxes. However, see *Religious Exemptions* in Publication 533, *Self-Employment Tax.*

The minimum amounts, above, apply after your earnings or income are first reduced by the new 7.65% deduction for figuring self-employment tax, discussed later.

For 1990, the maximum amount subject to self-employment tax is $51,300. No self-employment tax is due on your self-employment income if the wages you received in 1990 as an employee were $51,300 or more, and were subject to social security tax, railroad retirement tax, or both.

Note. If you were a U.S. Government employee subject only to the 1.45% Medicare (hospital insurance benefits) tax, and your combined wages and self-employment earnings were in excess of $51,300, compute your self-employment tax by using the worksheet in the Form 1040 instructions for Schedule SE.

The Medicare tax (including use of the worksheet mentioned above) applies to most state and local government employees hired after March 31, 1986, and to state and local employees hired on or before that date who are covered by voluntary agreements with the Secretary of Health and Human Services.

Estimated income tax. If you estimate your income tax for 1991, you must also include an estimate of your self-employment tax. See *When to file your return and pay the tax* in Chapter 1.

Self-Employment Income

You are probably self-employed if you are a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself. Certain fishing crew members are also considered to be self-employed.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do on the side in addition to your regular job, may also be self-employment.

Some types of income, such as interest, may or may not be self-employment income. The source from which your income is received and your involvement in the activity from which your income is received will determine whether it is self-employment income.

Some common types of income are listed here. For a more complete discussion about self-employment income, see *Self-Employment Income* in Publication 533, *Self-Employment Tax.*

Real estate rent. Rent from real estate and personal property leased with real estate is not self-employment income. However, if you are a real estate dealer and received rent in the course of your trade or business, the rental income and related deductions are included in figuring self-employment income.

Interest. Interest is not self-employment income unless you receive it in your trade or business, such as interest on accounts receivable.

Dividends. Dividends on securities are not self-employment income unless you are a dealer in securities.

Capital gains and losses. Capital gains and losses, such as gain or loss on the sale of investment property, are excluded from self-employment income.

Other gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of depreciable property or other fixed assets used in your trade or business are not included.

However, amounts recaptured under sections 179(d)(10) and 280F(b)(3) of the Internal Revenue Code because the business use of the property was reduced to 50% or less are taken into account in figuring your net earnings from self-employment. This does not include amounts recaptured on the disposition of property.

Wages and salaries. Wages that are received for services performed as an employee and that are covered by social security tax or by railroad retirement tax are not self-employment income. Also, tips received for work done as an employee are excluded from self-employment income.

Net Self-Employment Income

Net earnings from self-employment normally include all of the items of business income and take into account business deductions allowed for income tax purposes. Net earnings from self-employment are determined using the same accounting method as used for income tax purposes.

If you have more than one trade or business, your net earnings from self-employment are the combined earnings from each of your businesses. A loss in one business will reduce the income earned in another. You must claim all allowable deductions, including depreciation, when figuring your net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

Deductions and exemptions. Your self-employment income should not be reduced by certain deductions and exemptions that are used when figuring income tax. Specifically, do not use:

1) Deductions for personal exemptions for yourself, your spouse, or dependents,
2) The standard deduction,
3) The net operating loss deduction,
4) The foreign expropriation loss deduction,
5) Nonbusiness deductions including contributions on your behalf to a pension, profit-sharing, or annuity plan, and
6) The self-employed health insurance deduction.

Example. You own a fishing boat and for the year your business had the following items:

Gross profit on sales	$32,500
Salaries	9,000
Fuel	2,700
Repairs	1,400
Other expenses	900
Gain on sale of equipment	350
Fire loss on boat	1,200
Net operating loss carryover	1,000

To figure taxable income, consider all the above items. But to figure ***net earnings from self-employment,*** use only the following:

Gross profit on sales		$32,500
Expenses:		
Salaries	$9,000	
Fuel	2,700	
Repairs	1,400	
Other expenses	900	
Total expenses		14,000
Net operating profit		$18,500

The $18,500 is your net earnings from self-employment. The sale of the equipment, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation. For other excluded income and deductions, see *Self-Employment Income* in Publication 533.

Figuring the Tax

There are three ways to figure self-employment net earnings. They are the regular method, the nonfarm optional method, and the farm optional method. The regular and the nonfarm optional methods apply to the fishing industry. For a discussion of all the methods, see Publication 533.

The nonfarm optional method is intended to permit continued coverage for self-employment tax purposes when your net profit for the year is small or you have a loss. You use the nonfarm optional method only to figure self-employment tax. Do not use it to figure your income tax.

The regular method and the nonfarm optional method differ in the way you determine net earnings. However, the kinds of excluded income, the minimum and maximum income limits, and the tax rate are the same for each method. The general rules for figuring self-employment tax are presented in the discussion of Short Schedule SE.

Tax rates. After 1989, the self-employment tax rate is 15.3%, and the 2% credit for 1989 has been replaced by the following two deductions:

- A deduction of half your self-employment tax for the year is taken as a business expense in figuring adjusted gross income. This is an income tax deduction only, and you deduct it on line 25 of your 1990 Form 1040. It is not a deduction in figuring net earnings from self-employment subject to self-employment tax.
- A deduction of 7.65% of your net earnings from self-employment is taken when figuring your self-employment tax. This deduction is allowed only in figuring self-employment tax, and you figure it on line 4 of your 1990 Schedule SE. It is not an income tax deduction.

Schedule SE. Schedule SE (Form 1040) is used to compute self-employment tax. This form is illustrated in Publication 533.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, it is independently subject to self-employment tax. If you both have self-employment income, each of you must file a separate Schedule SE (Form 1040).

Short Schedule SE

Most taxpayers can use the *Short Schedule SE* (Section A) to figure self-employment tax.

However, the following taxpayers must use *Long Schedule SE* (Section B). For more information on this schedule, see Publication 533.

1) Ministers not taxed on minister earnings (with IRS consent), but who owe self-employment tax on other earnings,
2) Government employees subject only to the 1.45% Medicare part of social security taxes, if wages plus self-employment earnings are more than $51,300,
3) Employees of a church or church-controlled organization that elected exemption from social security taxes,
4) Individuals with tip income subject to social security tax that was not reported to their employers, and
5) Individuals who want to use one of the optional methods to figure self-employment tax.

Use the following steps to figure the tax:

Step 1. Figure what your earnings from self-employment are. Under the regular method, the net income from your business or profession is generally your net earnings from self-employment. Net income is figured by subtracting all allowable business expenses and deductions from gross business income.

Step 2. After you have figured your net earnings from self-employment, determine how much of your net earnings are subject to self-employment tax. Your net earnings are reduced by the new 7.65% deduction for figuring self-employment tax, and there is both a minimum and a maximum income limit.

New 7.65% deduction for figuring self-employment tax. Multiply your net earnings by 0.9235 for this new 7.65% deduction (100% − 7.65% = 92.35% or 0.9235).

Minimum income. You must have $400 or more of net earnings from self-employment after reduction by the new 7.65% deduction to be subject to the tax. If your net earnings are less than $400, you do not have to file Schedule SE (Form 1040) or pay the tax. If you are an employee of a church or qualified church-controlled organization that is exempt from social security taxes, you must pay the self-employment tax if you are paid $100 or more in a year. However, see *Religious Exemptions* in Publication 533.

Maximum income. No more than $51,300 of your net earnings in 1990 is subject to any combination of self-employment tax, social security tax, or railroad retirement tax. If you have more than $51,300 in income, you pay these taxes only on $51,300.

If you have wages in 1990 that are subject to social security tax, subtract them from $51,300 to

arrive at the maximum amount subject to self-employment tax. If your wages subject to social security tax are $51,300 or more, you do not have to pay self-employment tax.

Step 3. After you determine how much of your net earnings are subject to self-employment tax, multiply that amount by the tax rate for 1990 of 15.3% (0.153). The result is the amount of self-employment tax you owe.

Example 1. During 1990, you have $30,000 in net earnings from self-employment, and receive no wages subject to social security tax. You multiply the $30,000 by 0.9235 for the new 7.65% deduction (100% − 7.65% = 92.35%), and the result is $27,705. Your self-employment tax is 15.3% (0.153) of $27,705, or $4,238.87.

Example 2. During 1990, you have $20,000 in net earnings from self-employment, and receive $15,000 in wages subject to social security tax. You multiply the $20,000 by 0.9235 for the new 7.65% deduction, and the result is $18,470. Since your wages subtracted from the $51,300 maximum for 1990 are more than $18,470 ($51,300 − $15,000 = $36,300), your tax is 15.3% (0.153) of $18,470, or $2,825.91.

Nonfarm Optional Method

The nonfarm optional method is figured on *Long Schedule SE* (Section B). By using the nonfarm optional method, you can continue your self-employment tax coverage when your net profit for the year is small or you have a loss. But you may not use this method to report an amount less than your actual net earnings from self-employment.

The nonfarm optional method is used only for self-employment income that does not come from farming. You may use this method if you meet all the following tests:

1) Your actual net earnings from nonfarm self-employment figured by the regular method, as shown on line 29 of Schedule C (Form 1040) and line 15a of Schedule K – 1 (Form 1065), are less than $1,733 (.9235 × $1,733 = $1,600.43).
2) Your net earnings from nonfarm self-employment are less than two-thirds of the total gross income you made from nonfarm self-employment.
3) You are self-employed on a regular basis. Self-employment on a regular basis means that your actual net earnings from self-employment are $400 or more in at least 2 of the 3 tax years before the one for which you use this method.
4) You have not previously used this method more than 4 years (there is a 5–year lifetime limit).

For more information on the nonfarm optional method, see Publication 533.

11. Employment Taxes

Important Changes for 1990

Maximum wages for social security taxes. The maximum amount of wages subject to social security taxes for 1990 is $51,300.

Tax rate for social security taxes. The tax rate for social security taxes for 1990 is 7.65% for both the employee and the employer. For 1991, the tax rate remains at 7.65%.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1990. For 1991, the tax rate decreases to 6.0%.

Federal tax deposit penalties. After 1989, the penalty for a late tax deposit is based on the length of time the deposit is late. See *Penalties*, later.

You may be required to withhold, report, and deposit employment taxes. If you have one or more employees, you may have to withhold federal income tax from their wages. You may also be subject to social security taxes under the Federal Insurance Contributions Act (FICA) and unemployment tax under the Federal Unemployment Tax Act (FUTA).

However, no withholding is required for crew members who are treated as self-employed individuals. You may be required only to file a Form 1099–MISC, *Statement for Recipients of Miscellaneous Income*, to report the payments made to these crew members. See *Certain Crew Members Considered Self-Employed*, later in this chapter.

Every employer subject to employment taxes must have an employer identification number. If you do not have one, you should get Form SS–4, *Application for Employer Identification Number*, from the Internal Revenue Service. You should file the completed application form with the Internal Revenue Service Center where you file your federal tax returns.

Who Are Employees?

Common-law rules are used to determine whether a person working for you is an employee for purposes of social security (FICA) taxes, federal unemployment (FUTA) tax, and federal income tax withholding. Under the common-law rules, anyone who performs services that are subject to the will and control of an employer, as to both what must be done and how it must be done, is an employee. It does not matter whether the employer allows the employee discretion and freedom of action, as long as the employer has the legal right to control both the method and the result of the services. Two of the usual characteristics of an employer-employee relationship are that the employer supplies the employee with tools and a place to work and the employer has the right to discharge the employee.

If you have an employer-employee relationship, it makes no difference how it is described. It does not matter if the employee is called an employee, or a partner, co-adventurer, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called. Also, it does not matter whether the individual is employed full or part-time.

No distinction is made among classes of employees. Superintendents, managers, and other supervisory personnel are all employees.

In doubtful cases, the facts will determine whether or not there is an actual employer-employee relationship. If you want the IRS to determine whether a worker is an employee, file Form SS–8 with your District Director.

Example 1. The Pan Fishing Co. engaged Mike Rose to captain one of its fishing trawlers. The trawler is a United States vessel of more than 10 net tons. The Pan Fishing Co. and Mike Rose entered into a contract of service within the United States. Mike hires a crew of 15 to operate the vessel. He offers to pay each crew member on the "lay" (sharing of the profit) basis. He and the crew members, except the engineer who is paid a straight fee, are jointly liable for any losses resulting from a voyage.

After the voyage, Mike sells the catch through a fish exchange, which deducts its fees from the proceeds. After deducting certain specified expenses (such as fuel, oil, etc.), he turns one-fourth of the proceeds over to Pan Fishing Co., less 5% which he keeps as his commission. From the remaining three-fourths, the expenses of food, bait, etc., are deducted. The remainder is then equally divided among the members of the crew and Mike.

The members of a fishing crew are generally employees either of the captain (if he is not an agent of the owner of the vessel) or of the vessel owner. Amounts paid to crew members on the "lay" basis are considered wages, and the agreements under which the crews are hired in these circumstances are contracts of hire.

In this example, Mike is acting as an agent of Pan Fishing Co.; therefore, the company is the employer. As an employer of a crew working on an American vessel under a contract entered into in the U.S., the company must withhold income tax and social security tax from the entire crew's wages, including Mike's and the engineer's. The company also must pay the employer's portion of the social security tax. Because the trawler is a vessel of more than 10 net tons with a crew of more than nine members, the company also must pay federal unemployment tax on these wages.

The value of meals and lodging is not subject to income tax withholding, and social security and federal unemployment taxes, however, because the company must furnish meals and lodging to the employees on board the vessel so that they can perform their services.

Example 2. Assume the same facts as in Example 1, except that Mike Rose is the owner-operator of the vessel and is in no way associated with Pan Fishing Co. In this situation, Mike is the employer for purposes of withholding income tax and FICA tax from the wages of the crew. He also must pay the employer's part of the social security tax. Because the vessel is more than 10 net tons with a crew of more than nine members, Mike must also pay federal unemployment tax on these wages.

Additional information. For more information on the employer-employee relationship, see *Who Are Employees?* in Publication 937, *Business Reporting*.

Certain Crew Members Considered Self-Employed

Wages paid to members of a crew on a fishing boat are not subject to federal income tax withholding, social security taxes, and the federal unemployment tax if all the following conditions are met:

1) The members do not get and are not entitled to get any money for their work (other than as provided in condition (2), below);
2) The members get a share of the catch or a share of the proceeds from the sale of the catch;
3) Each member's share depends on the size of the catch; and
4) The operating crew of the boat (or each boat from which a member gets a share for a fishing operation involving more than one boat) usually numbers less than 10.

Each member of the crew that meets these conditions is considered self-employed. The earnings of these crew members are considered

trade or business income, and therefore subject to self-employment tax. See Chapter 10, *Self-Employment Tax.*

Example 1. Mike Jones, an owner of a fishing boat of more than 10 net tons, employs a captain and eight others to work as crew members on the boat. The proceeds from the sale of the catch offset boat operating expenses, including bait, ice, and fuel, and the balance is divided 60% among the captain and the crew members and 40% between Mike and the captain. Between voyages, the crew members do not receive any additional compensation, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch. However, the mate, the engineer, and the cook get an additional payment from Mike of $25 each. The payment does not depend upon the boat's catch. Since the mate, the engineer, and the cook get this additional payment that does not depend on the amount of the catch, they are not considered self-employed. The $25 payment and their share of the proceeds from the catch are subject to federal income tax withholding, social security taxes, and the federal unemployment tax.

Since the other six crew members, including the captain, do not get any additional pay and are members of an operating crew of fewer than 10 members, they are considered self-employed. Mike does not have to withhold federal income tax or social security taxes from their pay. They must pay self-employment tax on their earnings.

Example 2. The facts are the same as in Example 1, except that, in addition to receiving a share of the catch, the captain and the other crew members are entitled to get $3 per hour for repairing nets, constructing new nets, splicing cable, and other incidental work while in port. Since the crew members are entitled to receive payment other than a share of the catch, they are not considered self-employed. The $3 per hour payment plus their share of the proceeds from the catch are subject to federal income tax withholding, social security taxes, and the federal unemployment tax.

Reporting requirements. The owner or operator of a boat must file with the IRS a completed Form 1099–MISC, *Statement for Recipients of Miscellaneous Income,* if any of the crew members work as self-employed individuals and all amounts must be reported. The $600 or more rule does not apply.

The operator of the fishing boat may combine the information required for each fishing operation if the type of catch and the percentage due the crew member and the operator remain the same.

If a crew member's share of the proceeds from the sale of the catch is shown as a dollar amount, then the operator will not have to provide information on the estimated value, weight, or type of the catch.

Form 1099–MISC must be filed with the IRS by February 28 following the calendar year in which the crew member was paid. See *Form 1099–MISC* in Chapter 16.

Statement to crew members. Every owner or operator who is required to file Form 1099–MISC must also furnish a statement to each crew member. You may use Copy B of Form 1099–MISC for this purpose. This statement must be furnished to all crew members by January 31 of the year following the calendar year in which the crew members were paid.

Unemployment tax. Self-employed crew members do not have to pay federal unemployment tax on their earnings. However, the owner or operator of the boat may be subject to federal unemployment tax on the earnings of crew members who perform services that come under the exceptions stated later in this chapter under *Federal Unemployment Tax.*

Record requirement. The owner or operator must keep a record of each catch. These records must be kept for 3 years after the tax year in which the catch occurred.

Income Tax Withholding

Generally, you must withhold income tax from wages that you pay an employee if the wages (whether paid in cash or in fish) are more than the amount of withholding allowances for that pay period. You should not withhold income tax from the wages of an employee who, by filing Form W–4, *Employee's Withholding Allowance Certificate,* certifies that he or she had no income tax liability last year and anticipates no income tax liability for the current year.

The amount to withhold is figured on gross wages without taking out social security taxes, union dues, insurance, etc. Several methods may be used to determine the amount of withholding. They are described in Circular E (Publication 15), *Employer's Tax Guide.*

Form W–4 for 1991. You should make new 1991 Forms W–4 available to your employees, and encourage them to check their income tax withholding situation for 1991. Those employees who owed a large amount of tax or received a large refund for 1990 may need to file a new 1991 Form W–4.

Effective date of Form W–4. You must put a new Form W–4 into effect no later than the start of the first payroll period ending on or after the 30th day from the date that you receive the new form. If you pay wages without regard to a payroll period, you must put the new Form W–4 into effect no later than the first payment of wages on or after the 30th day from the date that you receive the new Form W–4.

Meals and lodging. Meals are not subject to income tax withholding if furnished for the employer's convenience and on the employer's premises. Lodging is not subject to withholding if furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

Backup withholding. In certain cases, the law requires payers to withhold income tax at 20% (backup withholding) on payments of interest, dividends, and patronage dividends. The backup withholding requirement also applies to rents, royalties, commissions, nonemployee compensation, and other payments that payers make in the course of commercial fishing or other business activities. The payer must withhold 20% of the payment if:

1) The payee does not furnish a taxpayer identification number to the payer;
2) IRS notifies the payer that the payee furnished an incorrect taxpayer identification number;
3) The payer is notified that the payee is subject to backup withholding for underreporting interest or dividends;
4) For accounts opened after 1983 on which interest or dividends were paid, the payee does not certify to the payer, under penalties of perjury, that he or she is not subject to backup withholding for underreporting interest or dividends; or
5) For accounts opened after 1983 on which interest or dividends were paid or payments by a broker or barter exchange were made, the payee does not certify to the payer, under penalties of perjury, that the taxpayer identification number furnished is correct.

Amounts withheld under the backup withholding provisions are reported on Form 941 or Form 941E. Form 943 filers must also report backup withholding on Form 941 (or Form 941E). You can combine these amounts with your employment taxes for deposit purposes or, if you choose to treat them separately, you can show the backup withholding amounts on Schedule A (Form 941), *Record of Federal Backup Withholding Tax Liability.* At the end of the year, these amounts are reported on information returns in the 1099 series. For more information on information returns and backup withholding, get a booklet titled: *1990 Instructions for Forms 1099, 1098, 5498, and W–2G.*

Form W–9, *Request for Taxpayer Identification Number and Certification,* may be used by payers to request payees to furnish a taxpayer identification number and to certify that the number furnished is correct.

Social Security Taxes

The Federal Insurance Contributions Act (FICA) provides for a federal system of old age, survivors, disability, and hospital insurance. This system is financed through social security taxes. Social security (FICA) taxes are paid by you and your employees. You, as an employer, must collect and pay the employee's share, and you must pay your own share of this tax. You must withhold it from your employee's wages, whether paid in cash or in fish, in much the same way as income tax, discussed earlier.

Family members. Social security does not cover the services of a child under the age of 18 who works for his or her parent in a trade or business. If these services are for work other than a trade or business, such as domestic work in the parent's private home, they are not covered by social security until the child reaches 21.

Federal unemployment does not cover the services of a child under the age of 21 who works for his or her parent (whether or not in a trade or business).

The above rules apply even if the child is paid regular wages. The wages for these services are not subject to social security or federal unemployment taxes. But the wages may still be subject to income tax withholding.

One spouse employed by another. The services of an individual who works for his or her spouse in a trade or business are covered by social security taxes, but not by federal unemployment taxes. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security and federal unemployment taxes.

Covered services of a child or spouse. The services of a child are covered by social security and federal unemployment, and the services of a married individual are covered by federal unemployment, if he or she works for:

1) A corporation, even if it is controlled by the child's parent or the individual's spouse;
2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child;
3) A partnership, even if the individual's spouse is a partner; or
4) An estate, even if it is the estate of a deceased parent.

Under these conditions, a child is not considered to work for his or her parent. Nor is a married individual considered to work for his or her spouse.

Payments in kind. Generally, payments in kind are subject to social security taxes the same as wages paid in cash. ***Meals and lodging,*** however,

may not be subject to social security taxes. Meals are not taxable wages if furnished for the employer's convenience and on the employer's premises. Lodging is not taxable if furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

No withholding allowances are allowed for social security taxes. A table showing the amount to be withheld from the employee is provided in Circular E. The employer's tax rate for 1990 is 7.65% and the employee's tax rate is also 7.65%. (For 1991, both tax rates are scheduled to remain at 7.65%.)

Limit. The wages subject to social security taxes are limited to the first $51,300 of wages you pay each employee during calendar year 1990.

Paying Social Security and Withheld Income Taxes

You must deduct and withhold income and social security taxes from the salaries and wages of your employees. You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees. If, for example, you deduct less than the correct tax from your employees' wages, you are still liable for the full amount.

If you must withhold income tax from wages or are liable for social security taxes, you must file Form 941, *Employer's Quarterly Federal Tax Return.* A return may never cover a period of more than one calendar quarter. Fill in all the information requested on the return, including your employer identification number.

Deposits of taxes. Your total liability for social security taxes and federal income tax withholding will determine whether deposits are necessary and, if so, how often they must be made. To help ensure proper crediting to your account when depositing taxes, write your employer identification number, "Form 941," and the tax period the deposit applies to on your check or money order. See Circular E for information on depositing social security taxes, withheld income taxes, and use of authorized depositaries.

If you must make deposits of taxes and you make timely deposits in full payment of the taxes due, you can file your quarterly return on or before the 10th day of the 2nd month following the period for which it is made. In this case, the due dates for 1991 are as follows:

Quarter	*Due dates*
January-February-March	May 10
April-May-June	Aug. 12
July-August-September	Nov. 12
October-November-December	Feb. 10, 1992

Seasonal or intermittent employers. If you are a seasonal or intermittent employer, you do not have to file Form 941 or Form 941E when you have paid no wages during a quarter. However, you must check the seasonal filer box on Form 941, or the intermittent filer box on Form 941E, on each return you file so IRS will not expect a return each quarter.

Penalties. There are criminal and civil penalties for willful failure to file returns and pay taxes when due, or for willful filing of false or fraudulent returns.

If you withhold income and social security taxes from employees and do not pay the taxes to IRS or deposit them, you may be subject to a penalty of 100% of the tax. If you are the person responsible for the collection and payment of withholding taxes, you can be subject to this penalty even if you are an officer or employee of a corporation or a member or employee of a partnership.

Federal tax deposit penalties. Beginning in 1990, the penalty for a late tax deposit is based on the length of time the deposit is late. The following penalties now apply for late deposits:

1) If the deposit is not more than 5 days late, the penalty is 2% of the underpayment.
2) If the deposit is more than 5 days late but not more than 15 days late, the penalty is 5% of the underpayment.
3) If the deposit is more than 15 days late, the penalty is 10% of the underpayment.
4) If the deposit is not made within 10 days after IRS issues the first notice demanding payment or by the day that notice and demand for immediate payment is given, the penalty is 15% of the underpayment.

Forms for employees. You must furnish copies of Form W–2, *Wage and Tax Statement,* to each employee from whom income or social security taxes has been withheld. You must also furnish it to employees from whom income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W–4. The Form W–2 must show the total wages and other compensation paid (whether or not they are subject to withholding), and the amounts deducted for income tax and social security taxes.

Fill in all the information required on the statement. More detailed information for preparing Form W–2 is contained in the *Instructions for Forms W–2 and W–2P.*

Form W–3. Employers must file Form W–3, *Transmittal of Income and Tax Statements,* annually to transmit Forms W–2 that were issued for the preceding year. Form W–3 and its attachments must be filed with the Social Security Administration on or before the last day of February following the calendar year for which the Forms W–2 are prepared.

Additional information. Circular E (Publication 15), *Employer's Tax Guide,* contains tables for withholding income and social security taxes. It also contains more information about employment taxes. You can get Circular E from the IRS Forms Distribution Center for your state.

Federal Unemployment Tax

You are subject to federal unemployment tax (FUTA) if during the current or preceding calendar year, you:

1) Paid total wages of $1,500 or more in any calendar quarter; or
2) Employed one or more employees for some part of at least one day during each of 20 different calendar weeks. The 20 weeks do not have to be consecutive. Nor does it have to be the same employee each week. Individuals on vacation and sick leave are counted as employees in determining your status.

These rules apply to federal unemployment tax, but not to social security taxes or withholding of income tax. Also, they do not apply to your spouse, parents, or children under age 21. See *Family members,* earlier, under *Social Security Taxes.*

Catching fish. Services performed in catching fish are exempt from federal unemployment tax except for:

1) Work related to catching salmon or halibut for commercial purposes; or
2) Work performed on or in connection with a vessel of more than 10 net tons.

However, work falling under items (1) and (2) above is exempt if the four conditions mentioned earlier under *Certain Crew Members Considered Self-Employed* are met.

Meals and lodging. Meals and lodging are not subject to federal unemployment tax if certain conditions, discussed earlier in *Payments in kind* under *Social Security Taxes,* are met.

Figuring the tax. The gross federal unemployment tax rate for 1990 is 6.2% of the first $7,000 in wages paid to each employee. (The tax rate is scheduled to decrease to 6.0% for 1991.) However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The net tax rate, therefore, can be as low as 0.8% (0.6% in 1991) if your state is not subject to a credit reduction. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit. However, you cannot take the credit for any state taxes you fail to pay. If for any reason you are exempt from state unemployment tax, the full 6.2% rate applies.

Form 940. If you are liable for the federal unemployment tax, an annual return must be filed on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* by January 31 following the close of the calendar year for which the tax is due. Any tax still due on that date is payable with the return.

For more information about the federal unemployment tax, including the deposit rules, see the instructions on Form 940.

Form 940–EZ. Form 940–EZ, a simplified version of Form 940, can be used by small employers: (1) who paid state unemployment taxes to only one state; (2) who paid the state taxes by the due date of Form 940–EZ; and (3) whose wages taxable for FUTA tax were also taxable for state unemployment tax.

Advance Payment of the Earned Income Credit

Employers are generally required to make payments to employees who have filed with them a Form W–5, *Earned Income Credit Advance Payment Certificate,* to receive advance payments of their earned income credit. This allows those employees to receive the benefit of their credit each payday rather than having a single amount credited to them later on their tax return.

The payment is added to the pay of the employees each payday. It is figured from tables in Circular E, *Employer's Tax Guide.* Employers reduce their liability for income tax withholding and social security taxes by the total amount of the advance earned income credit payments made. For more information, see *Advance Payment of Earned Income Credit* in Publication 937.

Earned income credit notification. You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the earned income credit (EIC). However, you do not have to notify employees who claim exemption from withholding on Form W–4, *Employee's Withholding Allowance Certificate.*

You can meet the notification requirement by giving each employee the official IRS Form W–2, *Wage and Tax Statement,* which contains the notification on the back of Copy C, or you can give each employee Notice 797, *Notice of Possible Federal Tax Refund Due to the Earned Income Credit (EIC).* You can also use your own written statement as long as it has the exact wording of Notice 797, or you can furnish substitute Forms W–2 containing the exact wording shown on the back of Copy C of the official Form W–2. You

must so notify each employee, either in person or by first class mail, with his or her 1990 Form W–2 or within one week before or after that time, unless you use a substitute Form W–2 as the notice. If you do not furnish Form W–2 on time, you must notify the employee about the EIC by the date Form W–2 was required to be furnished. If Form W–2 is not required, you must notify the employee about the EIC by February 7, 1991.

You may request supplies of Notice 797 by calling the IRS toll-free telephone number 1–800–TAX–Form (1–800–829–3676).

12. Capital Construction Fund

The Capital Construction Fund (CCF) is a special investment program administered through the National Marine Fisheries Service (NMFS). This program allows you, as a commercial fisherman, to enter into an agreement with the Secretary of Commerce to invest part of your income in an interest-bearing trust fund (savings accounts, stocks, bonds, etc.). These funds are to be used to acquire or construct a new fishing vessel or to reconstruct or recondition one you already own.

Qualifying vessels. If you are a citizen of the United States who owns or leases an eligible vessel, you may enter into an agreement to establish a CCF. To be eligible, a vessel must:

1) Be built or rebuilt in the United States,
2) Have a home port in the United States if it weighs between 2 and 5 net tons,
3) Be documented under the laws of the United States if the vessel weighs 5 net tons or more, and
4) Operate in the foreign or domestic commerce of the United States or the fisheries of the United States.

Deposits. Although you may have only one CCF, the fund has three separate bookkeeping accounts. These accounts are:

1) The capital account,
2) The capital gain account, and
3) The ordinary income account.

While a deposit to the capital account does not generate a CCF tax deduction, and a deposit to a capital gain account defers tax on the capital gain part of a sale or other disposition, a deposit to the ordinary income account creates an immediate income tax reduction.

Deductions. If you enter into a CCF agreement, you may take a deduction for the investment when figuring taxable income, but not when figuring self-employment income. For income tax purposes, you reduce taxable income by the amount contributed to the fund up to your taxable income for the year or the taxable income from fishing operations, whichever is less. This limit is not affected by a net operating loss (NOL) carryback.

You reduce taxable income by listing the contribution as an expense on line 27a of Schedule C. This reduction must be added back to figure self-employment income. Do this in a separate explanation (attached to the return) and enter the "increased" income on line 2 of Schedule SE (Form 1040).

Withdrawals. Withdrawals from a CCF account, approved by the NMFS for payment towards fishing vessels you will construct, reconstruct, or acquire with the money in your CCF account, are qualified withdrawals. Any other withdrawal is a nonqualified withdrawal. A qualified withdrawal from either the ordinary income account or the capital gain account reduces the depreciable basis of your fishing vessel by 100% of the withdrawal.

Nonqualified withdrawals. Nonqualified withdrawals from the ordinary income account are included in ordinary income in the year the withdrawal is made. The income is reported on line 6 of Schedule C (Form 1040), but excluded from self-employment income. Report this information in a separate explanation (attached to the return) and enter the "reduced" income on line 2 of Schedule SE (Form 1040). Nonqualified withdrawals are subject to the maximum rate of income tax. In addition, interest is assessed on the additional tax due to a nonqualified withdrawal.

Alternative minimum tax. Deposits made by a corporation to a CCF are treated as an adjustment used in figuring alternative minimum taxable income. For information on the alternative minimum tax for corporations, see Publication 542, *Tax Information on Corporations.*

Dispositions. Gain on the disposition of a vessel covered by an agreement is excluded from income tax if the net proceeds from the sale or other disposition of, or from insurance on, the vessel is deposited into the fund. Ordinary income from depreciation recapture is also excluded from tax. In addition, earnings from investment and reinvestment of amounts held in the fund are excluded from gross income.

More information. A publication on the CCF is available from:

National Marine Fisheries Service
Capital Construction Fund Program
1335 East-West Highway
Silver Spring, MD 20910
Telephone: (301) 427–2393

13. Excise Taxes

You may be eligible to claim a credit or refund for excise taxes paid on:

- Fuel used in commercial fishing,
- Fuel used for off-highway business purposes, or
- Diesel fuel used for any reason in boats and stationary motors.

Also, you may be eligible to claim a credit or refund as the original purchaser of a diesel-powered car, van, or light truck. See *Diesel-powered Cars, Vans, and Light Trucks,* later.

You may be able to buy diesel fuel tax free instead of buying the fuel tax paid and then filing for a credit or refund. In addition, your supplier of gasoline may be able to sell you gasoline for use in commercial fishing at a price that does not include the excise tax. See *How to Buy Fuel Tax Free,* later.

For information about other excise tax credits and refunds available to other professions, see Publication 378, *Fuel Tax Credits and Refunds.*

Fuel Used In Commercial Fishing Boats

You may be eligible to claim a credit or refund of excise tax included in the price of fuel you use in a vessel employed in the fisheries or whaling business.

Boats used in fishing include only watercraft used in taking, catching, processing, or transporting fish, shellfish, or other aquatic life for commercial purposes, such as selling or processing the catch, on a specific trip basis. Both fresh and salt water fisheries are included. Commercial fishing boats do not include watercraft used on a specific trip for both sport fishing and commercial fishing. Fuel used in commercial fishing also does not include fuel used in aircraft even though used to locate fish.

Off-Highway Business Use

In addition to claims for excise taxes paid on fuels used in commercial fishing, you may be eligible to claim a credit or refund for fuels used in off-highway business use.

Off-highway business use. Off-highway business use of fuel is any use in a trade or business or in any income-producing activity. The use must not be in a highway vehicle registered for use on public highways.

Highway vehicle. Highway vehicle includes any self-propelled vehicle designed to carry a load over public highways, whether or not also designed to perform other functions.

It does not matter if the vehicle is designed to perform a highway transportation function for only a particular type of load, such as passengers, furnishings, and personal effects (as in a house, office, or utility trailer), or a special kind of cargo, goods, supplies, or materials. It does not matter if machinery or equipment is specially designed (and permanently mounted) to perform some off-highway task unrelated to highway transportation except to the extent discussed in the next paragraph. Examples of vehicles that are designed to carry a load over public highways are passenger automobiles, motorcycles, buses, highway-type trucks, and truck tractors.

Vehicles not considered highway vehicles. Generally, the following kinds of vehicles are not considered highway vehicles:

- Specially designed mobile machinery for nontransportation functions. A self-propelled vehicle is not a highway vehicle if the chassis—
  a) Has permanently mounted to it machinery or equipment used to perform certain operations (construction, manufacturing, drilling, mining, timbering, processing, farming, or operations similar to any of these) if the operation of the machinery or equipment is unrelated to transportation on or off the public highways,
  b) Has been specially designed to serve only as a mobile carriage and mount for the machinery or equipment, whether or not the machinery or equipment is in operation, or
  c) Could not be used, because of its special design, as part of a vehicle designed to carry any other load without substantial structural modification.
- Vehicles designed for off-highway transportation. A self-propelled vehicle is not a highway vehicle if—
  a) The vehicle is designed primarily to carry a specific kind of load other than over the public highway for certain operations (construction, manufacturing, mining, processing, farming, drilling, timbering, or similar operations), and
  b) The vehicle's use of carrying this load over public highways is substantially limited or impaired because of its design. For purposes of this requirement, account may be taken of whether the vehicle may travel

at regular highway speeds, requires a special permit for highway use, or is overweight, overheight, or overwidth for regular highway use.

A ***diesel-powered highway vehicle*** is any highway vehicle that uses diesel fuel for propulsion.

A ***public highway*** includes any road (federal or state highway, or city street) in the United States that is not a private roadway.

Registered. A vehicle is considered registered when it is:

1) Registered for highway use under the law of any state, the District of Columbia, or any foreign country, or
2) Required to be registered for highway use under the law of any state, the District of Columbia, or any foreign country in which it is operated or situated.

Any highway vehicle operated under a dealer's tag, license, or permit is considered registered. A highway vehicle is not considered registered solely because there has been issued a special permit for operation of the vehicle at particular times and under specified conditions.

Fuel used in power take-offs. A credit or refund is not allowed for fuel used in the motor of a highway vehicle that also operates special equipment by means of a power take-off or power transfer. It does not matter if the special equipment is mounted on the vehicle. For example, there is no credit or refund on gasoline used to operate the mixing unit on a concrete-mixer truck when the mixing unit is operated by a power take-off from the motor of the vehicle. Similarly, fuel used in the motor of a fuel-oil delivery truck to operate the pump on the truck for discharging the fuel into the customer's storage tank does not qualify for a credit or refund of tax.

If a registered highway vehicle is equipped with a separate motor to operate the special equipment, such as a refrigeration unit, pump, generator, or mixing unit, the fuel used in the separate motor qualifies. When fuel is drawn from the same tank that supplies fuel for propelling the vehicle, you must figure the quantity used in the separate motor operating the special equipment. Your reasonable estimate of the amount of fuel used will be accepted for a credit or a refund. The figure must be based, however, on operating experience and supported by your records. Devices to measure the number of miles the vehicle has traveled, such as hubometers, may be used to figure the number of gallons of fuel used to propel the vehicle. Add to this amount the fuel consumed while idling or warming up the motor preparatory to propelling the vehicle.

Fuel lost or destroyed through spillage, fire, or other casualty is not treated as fuel used in an off-highway business use.

Fuels used in stationary machines such as generators, compressors, power saws, and similar equipment; for cleaning purposes; in forklift trucks and bulldozers; and in cars and trucks operating off the highway in construction, mining, or timbering activities, if the vehicles are neither registered nor required to be registered, are examples of fuels used in off-highway business uses.

Diesel Fuel Used for Nontaxable Purposes

In addition to claims for excise taxes paid on fuels used in commercial fishing boats, you may be eligible to claim a credit or refund for tax-paid diesel fuels used for nontaxable purposes. Nontaxable uses of diesel fuel include both business and personal uses of diesel fuel in boats, nonhighway vehicles, and stationary motors.

How To Buy Fuel Tax Free

Instead of buying diesel fuel tax paid and then filing a claim for credit or refund when the diesel fuel is used for a nontaxable use, you may be eligible to buy it tax free. You may be able to buy gasoline at a tax-excluded price for use in a boat used in the commercial fishing business.

Diesel Fuel

You may be able to buy diesel fuel tax free for uses **other than** use in a diesel-powered highway vehicle. The uses include:

1) Use in any boat,
2) Use in stationary machines such as generators, compressors, or similar equipment, or
3) Use in any vehicle that is not a highway vehicle such as a forklift.

In order to buy diesel fuel tax free, you must buy from a supplier who is registered with the IRS to sell diesel fuel tax free. Although you do not have to be registered with the IRS to buy diesel fuel tax free, you must give your supplier a signed exemption certificate that states your name, address, taxpayer identification number (TIN), and intended nontaxable use.

Exemption certificate. The following is an acceptable exemption certificate:

Date_____
The undersigned buyer ("Buyer") hereby certifies that:
(Check applicable type of certificate)
_____ The diesel fuel specified in the accompanying order, or on the reverse side hereof, or
_____ The (quantity) _____ of diesel fuel ordered by the Buyer
for a period beginning on
(date)_____ and ending on
(Date)_____ (the period not to exceed 12 calendar months)
will be used for (state intended nontaxable use, such as use in a boat, etc.)_____
If this diesel fuel is resold or used for a purpose other than as stated in this certificate, then the Buyer may be subject to tax.
Buyer will be prepared to establish by satisfactory evidence the purpose for which Buyer used the product bought under this certificate.
Buyer understands that any fraudulent use of this certificate to buy any diesel fuel free of tax may subject the Buyer to penalties of perjury, which may include fine or imprisonment.
TIN_____
Signature_____
Title_____
Address_____

The information required by the exemption certificate may be transmitted from you to your supplier by any convenient means and may be preprinted on any business form normally used by you to transfer information to your supplier. You may give a separate exemption certificate for each purchase or you may use one certificate to cover all purchases from a particular seller for up to a year.

Buyers who use diesel fuel for both taxable and nontaxable purposes may buy tax free **only** the amount of diesel fuel that they reasonably project at the time of the purchase to use for nontaxable purposes.

Gasoline. Your supplier may be able to sell you gasoline at a tax-excluded price only for use in a ***vessel employed in commercial fishing.*** You may not buy gasoline for any other purpose at a tax-excluded price.

Your supplier does not have to be registered with the IRS in order to sell you gasoline at a tax-excluded price. Your supplier may be eligible to claim a credit or refund of the excise tax on the gasoline sold to you at a tax-excluded price for use in commercial fishing. Refer your supplier to Publication 510, for details.

In order to buy gasoline at a tax-excluded price, you must give your supplier a signed certificate that identifies you and states how you will use the gasoline. The certificate need not be renewed as long as the information it contains continues to be correct.

Exemption certificate. The following is an acceptable exemption certificate:

Date_____
The undersigned ("Buyer") hereby certifies that Buyer bought or will buy for use in a vessel employed in the fisheries business
(Check the applicable type of certificate)
_____ The (quantity)_____ of gasoline, or
_____ ALL the gasoline it buys:
at a price that does not include the gasoline excise tax from:
_____ (Name of seller)
_____ (Address of seller)
If the gasoline is not used as specified above, Buyer will so notify the person to whom Buyer gives this certificate. Buyer has not and will not claim a refund under section 6421 of the Internal Revenue Code for this gasoline tax.
Buyer understands that Buyer or any other party may, for fraudulent use of this certificate, be subject under section 7201 to a fine of not more than $10,000, or imprisonment for not more than 5 years, together with the costs of prosecution.
TIN_____
Signature_____
Title_____
Address_____

Diesel-Powered Cars, Vans, and Light Trucks

If you bought a qualified diesel-powered highway vehicle, you may be eligible for a one-time credit or refund. You claim the credit on the tax return for the year of purchase. To see if you are eligible to use Form 843, *Claim for Refund and Request for Abatement,* to claim a refund for the purchase of a diesel-powered highway vehicle, read *How To Claim a Credit or Refund,* later.

A ***qualified diesel-powered highway vehicle*** is one that:

1) Has at least four wheels,
2) Has a gross vehicle weight rating of 10,000 pounds or less, and
3) Is registered for highway use in the United States under the laws of any state.

Original purchaser. You must be the original purchaser. An original purchaser is the first person to buy a new qualified diesel-powered vehicle after January 1, 1985, for use other than resale.

Amount of credit or refund. The credit or refund for 1984—1993 models is $102 for a car, and $198 for a light truck or van. A van is a vehicle with no body sections protruding more than 30 inches ahead of the leading edge of the windshield.

Basis reduction. The basis of any qualified diesel-powered highway vehicle must be reduced by the amount of credit or refund payable for such vehicle. The basis reduction is considered to occur on the date of purchase.

Example. In 1990, you purchased a new diesel-powered truck for $9,198. The $198 credit or

refund can be claimed only for the tax year in which you purchased the truck (1990). The basis of your truck is reduced by $198 to $9,000 on the date you purchased it.

How To Claim a Credit or Refund

If you purchase the fuel tax paid and you use it in commercial fishing, you generally can claim a credit or refund of the excise taxes included. No credit or refund is allowed for any fuel purchased tax free.

Taxpayer identification number. To file a claim for credit or refund, you must have a taxpayer identification number — either a social security number or an employer identification number.

Recordkeeping. You must keep at your principal place of business records that will allow the IRS to verify the amount claimed. No special form is required, but the records should show:

1) The total number of gallons purchased and used during the period covered by your claim,
2) The dates of the purchases,
3) The names and addresses of suppliers and amounts purchased from each during the period covered by your claim,
4) The purpose for which the fuel was used, and
5) The number of gallons used for each purpose.

It is important that your records show separately the number of gallons used for each purpose that qualifies as a claim. Do ***not*** submit copies of vouchers or checks showing the purchase of and payment for fuels for which you claim a credit or file a claim for refund.

Amount of credit or refund. The rate of tax imposed on fuels changed during 1990. Before September 1, 1990, the rate of tax included the Leaking Underground Storage (LUST) tax. After August 31, 1990, the rate of tax does not include the LUST tax. The rate of tax shown on your record of sale determines the amount of credit or refund you may claim.

The rate of tax before September 1, 1990 was:

- Gasoline: 9.1 cents
- Gasohol: 3.1 cents
- Diesel fuel: 15.1 cents
- Special motor fuels: 9.1 cents
- Gasoline used in aviation: 12.0 cents or 9.0 cents
- Aviation fuels (other than gasoline): 14.0 cents

The rate of tax after August 31, 1990 is:

- Gasoline: 9.0 cents
- Gasohol: 3.0 cents
- Diesel fuel: 15.0 cents
- Special motor fuels: 9.0 cents
- Gasoline used in aviation: 12.0 cents or 9.0 cents
- Aviation fuels (other than gasoline): 14.0 cents

Caution: At the time this publication went to print, Congress was considering legislation that will increase the excise tax on gasoline and restore the LUST tax. For more information on this tax and other tax law changes, see Publication 553, *Highlights of 1990 Tax Changes.*

Claiming a Credit

A claim for credit is made on Form 4136, *Credit for Federal Tax on Fuels,* and attached to your income tax return. Do not claim a credit on Form 4136 for any excise tax for which you have already filed a refund claim on Form 843.

How to claim a credit. How you claim a credit depends on whether you are an individual, partnership, corporation, S corporation, trust, or farmers' cooperative association.

Individuals. Individuals claim the credit on line 60 of the 1990 Form 1040. Even though you may not otherwise have to file an income tax return, you must do so to obtain a fuel tax credit. See instructions accompanying Form 1040.

Partnerships. Partnerships cannot claim the credit on Form 1065, *U.S. Partnership Return of Income.* A partnership must attach a statement to Form 1065, showing the number of gallons of each fuel used and allocating the gallons to each partner according to the percentage of the partnership owned. Each partner then claims the credit on his or her income tax return for his or her share of the fuel used by the partnership.

Corporations. Corporations use line 32g of Form 1120, *U.S. Corporation Income Tax Return,* or line 23c of Form 1120–A, *U.S. Corporation Short-Form Income Tax Return,* to claim the credit.

S corporations. S corporations use line 23c of Form 1120S, *U.S. Income Tax Return for an S Corporation,* to claim the credit.

Farmers' cooperative associations. Farmers' cooperative associations required to file Form 990–C, *Farmers' Cooperative Association Income Tax Return,* use line 32g to claim the credit or refund.

Trusts. Trusts use line 24g of Form 1041, *U.S. Fiduciary Income Tax Return,* to claim the credit.

When to claim a credit. You can claim a fuel tax credit on your income tax return for the year the fuels were used or on an amended return for credit filed within the time prescribed by law. Ordinarily, you have the ***later*** of 3 years from the date your original return was filed (a return filed early is considered filed on the due date) or 2 years from the time the tax was paid.

Claiming a Refund

A claim for refund is filed on Form 843. You may be eligible to claim a refund during 1991 rather than waiting until you file your 1991 income tax return to claim a credit.

The claim must include a statement showing:

1) The total number of gallons used (during the period covered by your claim) multiplied by the appropriate rate of tax,
2) The purpose or purposes (for example, the off-highway business use) for which the fuels were used,
3) The amount used for each purpose (a list of uses by general categories will do), and
4) The Internal Revenue Service Center where you filed your last income tax return (if applicable).

Quarterly refund claim. A quarterly refund claim can be filed for any of the first three quarters of your tax year for which you qualify. To qualify for a quarterly refund, you must be claiming:

1) At least $1,000 for gasoline used for nontaxable purposes such as off-highway business use during the quarter,
2) At least $1,000 for special motor fuel used for nontaxable purposes such as off-highway business use during the quarter and for the credit for diesel-powered highway vehicles, or
3) At least $750 for diesel fuel or aviation fuel used for nontaxable purposes during the quarter.

A special rule for diesel fuel and aviation fuel allows you to aggregate the amount of fuel used in each quarter. If the amount of your claim is less than $750 in a quarter, but the amount of the claim for more than one quarter is at least $750, you may file a claim for the quarter for which the combined total is at least $750.

Fourth quarter claims. You cannot file a quarterly claim for refund for the fourth quarter of your tax year. Claims for the fourth quarter must be filed as a credit on your income tax return.

When to file. You must file a quarterly claim by the last day of the third month following the end of the quarter for which the claim is being filed. If the claim is late, a refund will not be allowed. Instead, the amount of disallowed refund is added to any claim for credit and claimed on your income tax return. Do not claim a credit against your income tax for any excise tax for which you filed a claim for refund.

Form 843 is filed in the same name and with the same IRS Service Center where the latest income tax return was filed. A partnership files a claim for refund in the name of the partnership, and one of the partners must sign it. A corporation files the claim in the name of the corporation and one of its officers must sign it.

Example 1. Captain Harry Jones reports his income on a calendar year basis. During July of 1990, he used 20,000 gallons of gasoline on his boat for commercial fishing purposes. Although he could file a quarterly claim for refund for the third quarter on Form 843 for the federal excise tax included in the 20,000 gallons, the captain choose to claim the credit on his 1990 income tax return. Therefore, he claimed a credit of $1,620 against his income tax liability. He cannot file a claim for refund for the gasoline excise tax.

Example 2. Pearl Steele used 15,000 gallons of tax-paid diesel fuel on her boat for commercial fishing purposes in April of 1990. She filed Form 843 for the second quarter and claimed a $2,265 refund. When Pearl files her 1990 income tax return, she cannot claim a credit for the 15,000 gallons of diesel fuel.

Including the Credit or Refund in Gross Income

Any credit or refund of excise taxes on fuels you receive must be included in your gross income if you claimed the taxes as an expense deduction that reduced your income tax liability. Do not include as income any credit or refund related to the purchase of a qualified diesel-powered highway vehicle.

The year a credit or refund is includible in gross income depends on whether you use the cash or accrual method of accounting.

Cash basis taxpayer. A cash basis taxpayer who files a claim for refund must include the refund in gross income for the tax year in which the refund is received. A cash basis taxpayer who claims a credit on an income tax return includes the credit in gross income for the tax year in which the income tax return is filed. If an amended return is filed claiming credit for the tax, include the tax refunded in gross income for the tax year in which it is received. For fishermen, the refund is reported on Schedule C, *Profit and Loss from Business.*

Example. Ed Brown, a cash basis fisherman, filed his 1990 Form 1040 on March 1, 1991. On Schedule C, he claimed $1,200 for gasoline used in his commercial fishing vessels. The $1,200 claimed as a deduction on Schedule C included

$100 of excise tax. Then, on Form 4136, Ed claimed the $100 excise tax paid on the gasoline as a credit. Ed must report the $100 as additional income on his 1991 Schedule C.

Accrual basis taxpayer. An accrual basis taxpayer must include the entire amount of the claim in gross income on Schedule C for the tax year in which the qualifying use occurred. It does not matter if the accrual basis taxpayer filed for a quarterly refund or claimed the entire amount as a credit.

Example. Todd Green, an accrual basis fisherman, filed his 1990 Form 1040 on April 15, 1991. On Schedule C, he claimed $1,855 for gasoline he had used in his commercial fishing vessels. The $1,855 claimed as a deduction on Schedule C included $155 of excise tax. Then, on Form 4136, he claimed $155 excise tax paid on the gasoline as a credit. He reported the $155 as additional income on his 1990 Schedule C.

14. The Examination and Appeals Process

We examine returns for correctness of income, exemptions, credits, and deductions.

Fairness If Your Return Is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1, *Your Rights as a Taxpayer,* explains the many rights you have as a taxpayer. You can get free publications by calling our toll-free number.

Pay only the required tax. You have the right to plan your business and personal finances in such a way that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly to all taxpayers.

Privacy and confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for information, exactly how we will use it, and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We use these examination results to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W-2 and 1099, with returns.

Arranging the examination. Many examinations are handled by mail. For information on this, get Publication 1383, *The Correspondence Process (Income Tax Accounts),* available free by calling our toll-free number 1-800-TAX-FORM (829-3676). If we notify you that your examination is to be conducted through a personal interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your return is examined in the IRS district where you live. But if it can be examined more quickly and conveniently in another district, such as where your books and records are located, you may ask to have the case transferred to that district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, C.P.A., an enrolled agent, or any other person permitted to represent a taxpayer during an examination, we will stop and reschedule the interview. We cannot suspend the interview if you are there because of an administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting and you can get a copy of the recording at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the examination.

Explanation of Changes

If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on the additional tax is figured from the due date of your return to the billing date. However, you will not be billed for more than 30 days additional interest, even if the bill is delayed. Also, you will not have to pay any more interest or penalties if you pay the amount due within 10 days of the billing date.

If you are due a refund, we can refund your money more quickly if you sign the agreement form. You will be paid interest on the refund.

Appealing the Examination Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor to discuss your case further. If you still don't agree with the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* This publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal. You can also get a free copy by calling us at our toll-free number.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction in Appeals, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Claims Court, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not yet pay the additional tax and you disagree about whether you owe it, you generally have the right to take your case to the Tax Court. Ordinarily you have 90 days from the time we mail you a formal notice (called a "notice of deficiency") telling you that you owe additional tax to file a petition with the Tax Court.

If you have already paid the disputed tax in full and filed a claim for refund (discussed later) for it that we disallowed (or on which we did not take action within 6 months), then you may take your case to the U.S. District Court or U.S. Claims Court.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* will help you more fully understand your appeal rights. You can get it free by calling our toll-free number.

Other Remedies

If you believe that tax, penalty, or interest was unjustly charged, you have rights which can remedy the situation.

Claims for refund. Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax is too much. You may claim a credit or refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return.*

You should file your claim by mailing it to the Internal Revenue Service Center where you filed your original return. File a separate form for each year or period involved.

Time for filing a claim. Claims for a credit or refund must be filed within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. There are exceptions to this time period if your claim is based on certain carryback items, foreign taxes, bad debts, worthless securities, or if you and the Service have agreed to extend the tax assessment period.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest, as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the applicable standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest which would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply to you. If you are a member of a partnership or a shareholder in a small business corporation, special rules (which may be different from those described here) may apply to the examination of your partnership or corporation items. The examination of these items is discussed in Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.* You can get this publication free by calling us at our toll-free number.

15. Sample Record System and Tax Forms

This chapter discusses a sample recordkeeping system and some commonly used tax forms. The records and forms discussed are illustrated at the end of the chapter.

You are not required to use this system. It is only an example of a simple system of keeping business records.

Sample Record System

The following pages discuss the records of a good bookkeeping system. Each type of record is keyed to the illustration at the end of the chapter by a bracketed number:

1) Daily Cash Receipts and Expenses Diary
2) Fishhouse Ticket
3) Monthly Summary of Receipts and Expenses
4) Annual Summary for Schedule C Entries
5) Depreciation Record
6) Crew Share—Compensation Record

This sample record system is a single-entry system used by Frank Carter, who is the owner-operator of a 32-foot fishing boat, the *Salem.* Frank uses the cash method of accounting. He has two crew members, Bill Brown and Joe Green, who are considered self-employed for social security tax (FICA) and federal income tax withholding purposes. See the discussion under *Certain Crew Members Considered Self-Employed* in Chapter 11. The boat's catch is divided: 76% to Frank and 12% to each crew member. Frank does not have to pay federal unemployment tax on the crew members' wages. See the discussion under *Federal Unemployment Tax* in Chapter 11.

Single-entry bookkeeping. This is a system based on the income statement. It can be a simple system and a very practical one if you are starting out in a small business. For tax purposes, the system records the flow of income and expenses through the use of a daily cash receipts and expenses diary, fishhouse tickets, and a monthly summary of receipts and expenses.

Books. Frank is not required to keep his records in bound books. Records are adequate if they show current income on the basis of an annual accounting period, such as a calendar year.

Keyed explanations. The following explanations are keyed to the corresponding numbers and letters on later illustrations.

[1] Daily Cash Receipts and Expenses Diary. This diary is used to record daily receipts and out-of-pocket expenses. Frank uses it if the payment of expenses cannot be made by check (for example, when he is in a foreign port) or for recording miscellaneous cash sales (for example, when he sells fish to tourists at the dock). He keeps the diary on the boat to record these transactions when they occur. He transfers these figures (income and expenses) to his accounting records on a weekly or monthly basis depending on how often he fishes. He might want to record other daily activities in his diary, such as those recorded in the example diary for January 2 and 3. It is also a good business practice to deposit all his daily receipts (cash and checks) in his business bank account and to pay all his bills by check. Checks are entered in the Monthly Summary of Receipts and Expenses, as discussed later.

[A] The cash receipts ($50.00) for January 2, 1990, and the cash payment ($9.04) for January 2, 1990, are taken from the Daily Cash Receipts and Expenses Diary, and are entered in the proper column on the Monthly Summary of Receipts and Expenses. The total of these daily entries is Frank's total monthly receipts and expenses.

[2] Fishhouse Ticket. Frank sells his daily catch to a fishhouse and receives a fishhouse ticket as a record of sales. Each ticket usually covers a specific period (for example, a week) and shows the amount of the receipts and expenses for each day Frank sells to the fishhouse. Expenses, such as ice and oil, incurred by Frank with the fishhouse, are included on the ticket and are deducted from the gross receipts.

Frank receives a net payment (income less expenses) as shown on each ticket for the weekly fishing activity. The weekly gross receipts and the weekly expenses are transferred to the Monthly Summary of Receipts and Expenses and are entered in the receipts column and in the expenses column. The ticket also shows the amount of the share of the catch due each crew member. This amount is entered under the crew shares column on the Monthly Summary of Receipts and Expenses.

The amount due each crew member is also carried to his Crew Share—Compensation Record. See item [6]. These tickets become part of the accounting records and should be retained along with other records.

[B] The weekly gross receipts ($1,254.60) are carried to the Monthly Summary of Receipts and Expenses to determine the gross receipts for the month of January. The weekly expenses ($356.05) are also transferred to the Monthly Summary to determine the total expenses for the month. The amount of the crew shares ($107.83 to Bill Brown and $107.83 to Joe Green) are carried to the Monthly Summary to determine expenses and crew shares for the month of January.

[3] Monthly Summary of Receipts and Expenses. Frank's gross receipts as shown on each fishhouse ticket and each cash receipt recorded in his Daily Cash Receipts and Expenses Diary are entered under the receipts column in the Monthly Summary of Receipts and Expenses. These entries are usually made on a weekly basis.

Checks drawn on Frank's business checking account are entered daily. All checks are prenumbered and every check number is accounted for in the narrow column provided for check numbers.

The more common expenses have their own headings across the sheet. Expenses that normally require numerous entries to be made, such as repairs, fuel, and galley supplies, are entered in a separate account column. Expenses or other items that normally have only one or two monthly payments are entered under the column marked "other."

[C] The monthly total of receipts ($3,789.10) is carried to the Annual Summary for Schedule C Entries. Similarly, Frank's monthly expenses for galley supplies ($92.90), fuel, bait, ice, crew shares, etc., are entered in the appropriate columns of the Annual Summary for Schedule C Entries.

[4] Annual Summary for Schedule C Entries. This annual summary of monthly income and expense totals provides final annual amounts to be entered on Frank's tax return. The entries on the annual summary are the totals from the monthly summary. As in the case of the Monthly Summary of Receipts and Expenses, there are separate columns for each major expense and for cash receipts.

[D] The gross receipts total from the annual summary is entered on line 1 of Schedule C.

[E] The annual expense total for repairs is carried from the annual summary and entered under "Repairs" on line 22 of Schedule C. Annual totals for rent, wages, taxes, and interest are entered on the appropriate lines of Schedule C. Other annual expenses not listed on Schedule C are entered as separate items under line 28.

[5] Depreciation Record. Another major item entered on Schedule C is the depreciation allowed on the depreciable assets used in the fishing business. The sample depreciation record shows an example of an item placed in service before 1981, depreciated using the straight-line method and sold in 1990 (see *Form 4797,* later). It also shows items placed in service after 1980 and before 1987 and depreciated using ACRS, and items placed in service in 1987, 1989, and 1990 that are depreciated using MACRS.

The depreciation record is maintained over the period for which Frank is depreciating the item. Depreciation must be taken in the year it is allowable. He cannot deduct in one year allowable depreciation he did not take in a prior year. The depreciation he may claim for the tax year is shown in his depreciation record as *Total Depreciation for 1990.*

Frank may elect to deduct part of the cost of certain depreciable property bought and placed in

service in his trade or business during the tax year. This is referred to as the "section 179 deduction." For more information on depreciation and the section 179 deduction, see Chapter 6.

The pickup truck was purchased new and placed in service in August 1990. Frank must use MACRS for the truck. Frank uses his truck 80% in his fishing business. The truck's gross vehicle weight is less than 6,000 pounds and it is a passenger automobile (see Chapter 6). Therefore, Frank's total depreciation and section 179 deduction cannot exceed $2,128. This is the $2,660 limit adjusted to reflect Frank's 80% use. He takes a $2,128 section 179 deduction and reduces his basis by this deduction ($8,000 – $2,128). The depreciable basis of Frank's truck is $5,872. However, Frank has claimed the maximum deduction he can take for the truck in 1990. Therefore, Frank takes no deduction using MACRS on the truck in 1990.

Frank's total depreciation for the year ($9,429) is carried from his depreciation record and entered on Form 4562, *Depreciation and Amortization* (illustrated). The depreciation ($9,429) claimed for the tax year is then carried from Form 4562 to line 13 of Schedule C (Form 1040). In reporting his depreciation deduction on Form 4562, Frank must complete Part V of the form, which applies to listed property. Because Frank's truck is listed property, he enters the amount of the depreciation on his truck in Section A of Part V. He uses line 23 because he used the truck more than 50% for business. Then, in Section B, he answers questions and provides recordkeeping information regarding the use of his truck.

[6] A Crew-Share—Compensation Record. This record is kept for each crew member regardless of whether the crew member is considered to be an employee or a self-employed individual for purposes of the social security tax (FICA) and federal income tax withholding. To determine if a crew member is considered a self-employed individual, see the discussion under *Certain Crew Members Considered Self-Employed* in Chapter 11. If the crew member does not qualify under that discussion, see the discussion under *Income Tax Withholding* and *Social Security Taxes* in the same chapter.

If the crew members are not considered self-employed, the sample record would show whether each employee is full- or part-time, the pay period, and the total wages each employee receives. The withholding deductions would also be recorded to show the computation of the employee's net pay. This information for each employee would then be used in preparing Form 941, *Employer's Quarterly Federal Tax Return.*

For this sample record system, both crew members qualify as self-employed. However, only the Crew-Share—Compensation Record of one of the crew members, Bill Brown, is illustrated. The record shows the share of the proceeds from the sale of the catches due Bill Brown, the percentage of each catch or proceeds from the catch due Bill, and the percentage of each catch due Frank, the owner-operator. Bill received cash from the sale of each catch; therefore, the recording of estimated value of the share of catch due Bill, the type of catch, and the total weight of each catch do not apply.

[F] The amounts recorded as shares paid in cash are transferred from the Monthly Summary of Receipts and Expenses.

[G] The yearly total of shares of catch paid to the crew member is entered on Form 1099–MISC (illustrated).

Copy A of Form 1099–MISC must be filed with the IRS on or before February 28 along with Form 1096. See the discussion under *Return Forms* in Chapter 1. Form 1099–MISC must be filed by the operator whether the crew members were paid in kind (fish) or received proceeds from the sale of the catch. Operators must give every crew member who is considered self-employed a statement showing the information reported on Copy A. Copy B of Form 1099–MISC may be used for this purpose. Copy B or an equivalent statement must be furnished to all crew members by January 31, 1991.

Bill Brown's tax identifying number is his social security number, which should be entered in the box provided.

Box 5. Frank enters the dollar amount of Bill's share of proceeds from the sale of the catch. Bill received $5,495.81 for 1990.

Tax Forms

The following are samples of filled-in Schedule C and Form 4797. These forms are illustrated later.

Frank attaches his completed schedules and forms in the correct order, using the sequence number arrangement. The sequence number is located below the year in the upper right corner of each schedule or form. He then attaches any of his own supplementary schedules or statements assembled in the same order as the forms and schedules they relate to.

Schedule C

As an owner-operator of a fishing boat, Frank Carter, a sole proprietor, shows the income and expenses of his business on Schedule C (Form 1040), which is filed as part of his Form 1040. Frank reports the net profit or loss from his business on line 12, Form 1040. If he has more than one business, Frank must prepare a separate Schedule C (Form 1040) for each business and attach each to his tax return. If Frank does not prepare a separate Schedule C for each business, he may have to pay a penalty because he did not properly report his income and deductions.

Frank pays self-employment tax because he operates his business as a sole proprietor. See Chapter 10.

The sample Schedule C is based on information taken from the sample records previously illustrated. Frank enters his principal business activity of "Fishing" on line A and his principal business code of "2246" (which he finds on page 2 of Schedule C) on line B. He uses the cash method of accounting (checks box 1 on line E) and files his return on a calendar year basis. Frank has no inventory, checks box 4 on line F, and does nothing on line G. Frank checks the "No" box for the question on line H because he does not maintain an office in his home. Line I is checked "Yes" because Frank materially participated in the operation of his fishing business.

Line 1. Frank's total sales of $60,288 includes all the fish caught and sold by him during the year. Since there were no returns and allowances (line 2), the gross receipts or sales of $60,288 are carried to line 3.

Line 5. Frank's gross profit is $60,288, the difference between lines 3 and 4.

Line 7. The gross income on Schedule C is the same as the gross sales from the business.

Line 10. Frank has total truck expenses of $505. He can deduct only 80% of $505, or $404, as a business expense.

Line 13. Before he can enter the deduction for depreciation on line 13, Frank figures his deduction on Form 4562 (illustrated). The information used to figure Frank's depreciation on Form 4562 is from his depreciation record, [5].

Line 15. The insurance expense of $3,291 represents Frank's 1990 portion of the premiums on the insurance policies covering his business property.

Line 16b. For 1990, Frank paid interest of $800 on bank loans incurred for the purchase of his boat.

Line 20b. Frank rents his mooring space. He paid $72 for his mooring space during the year.

Line 21. Frank's repairs of $4,593 represent $3,600 of vessel repairs and $993 of gear repairs during the year.

Line 22. Frank paid $1,713 for galley supplies and $4,751 for bait and ice during 1990.

Line 23. He paid a state license fee of $35.

Line 26. Frank paid total crew-shares of $10,992 to his crew members and entered this amount on line 26. He does not include the amounts he draws for personal use. He does not qualify for the jobs credit.

Line 27a. Other business expenses not listed elsewhere on Schedule C are listed separately in the spaces provided.

Line 28. His total expenses allowable on Schedule C amount to $42,447.

Line 29. Frank carries his net profit of $17,841 to line 12, Form 1040. He computes his self-employment tax on Schedule SE (Form 1040).

Form 4797

On January 5, 1990, Frank sold one of his two fishing boats for $65,000. The boat, *Chatham,* which was originally purchased on January 3, 1980, for $50,000, had an estimated useful life of 16 years and a salvage value of $10,000. The adjusted basis of the boat on January 5, 1990, was $25,000. Since the boat was depreciable property held over one year and was sold at a gain, Frank reports the sale first in Part III of Form 4797.

Ordinary gain from depreciation is computed on lines 19 through 25(b). In this example, the total gain of $40,000 (from line 24) is compared with the total depreciation allowed or allowable ($25,000) on line 25(a) and the smaller of these two amounts ($25,000) is entered on line 25(b). This is Frank's ordinary gain from depreciation.

Since he has no other transactions that must be included in Part III, he will go to the *Summary of Part III Gains* and complete lines 30 through 32. The total gain ($40,000) and the ordinary gain due to depreciation ($25,000) are entered in the *Summary of Part III Gains.* The amount of ordinary gain ($25,000) is carried to Part II and entered on line 13. Since this is the only entry (in this example) in Part II, Frank enters the $25,000 on lines 17, 18, and 18(b)(2) of Part II and also on line 15, Form 1040. The amount on line 32 is carried to line 5 of Part I. Since Frank has no section 1231 losses from prior years (line 8) and no other entries in Part I, he enters the $15,000 gain on lines 6 and 7. He also enters $15,000 on Schedule D (Form 1040) as long-term capital gain. Schedule D is not illustrated.

[1]—**Daily Cash Receipts and Expenses Diary**

Date	Item
1/3	Sold 50# fish at dock to tourist Amount $50.00
1/3	Paid for bait - Bob's Bait and Ice Amount $9.04
1/4	Winch broke down in early morning Went looking for parts
1/4	Talked fish prices with Joe Smith Looks like $1.07/lb

[A]

[2]—**Fishhouse Ticket**

Humble Seafood Co.

Boat: Salem — Date: 1/6/90

Catch: 208 lbs @ 1.05	$218.40
432 lbs @ 1.10	$475.20
510 lbs @ 1.10	$561.00

Expenses:		Gross:	$1,254.60
Oil	$179.65	Expenses:	356.05
Ice	176.40	Net	898.55
		Share	107.83
Total Expenses	$356.05	Share	107.83

[B]

19 90 Date		Descriptions	Ck. No.	Amount Receipts	Amount Expenses	Galley Supplies	Fuel	Moorage
JAN	3	Marine Supply Co.	75		300 00			
[A]	3	Sold Fish-dock	/	50 00				
	3	Bob's Bait and Ice	/		9 04			
	4	Frank Carter (withdrawal)	76		200 00			
	6	Shark Oil Co.	77		27 58		27 58	
	6	White's Grocery	78		92 90	92 90		
	7	Humble Seafood Co.	/	1,254 60				
[B]	8	Humble Seafood Co.	/		356 05		179 65	
	8	Bill Brown (crew share)	/		107 83			
	8	Joe Green (crew share)	/		107 83			
	8	Frank Carter (withdrawal)	79		200 00			
	13	National Bank (boat loan)	80		250 00			
	13	Peter's Pier	81		6 00			6 00
	13	Frank Carter (withdrawal)	82		200 00			
	15	Humble Seafood Co.	/	1,321 80				
	15	Humble Seafood Co	/		401 49		201 84	
	15	Bill Brown (crew share)	/		110 44			
	15	Joe Green (crew share)	/		110 44			
	20	Bass Insurance (boat)	83		241 75			
	20	Joe's Garage	84		21 03			
	20	Frank Carter (withdrawal)	85		200 00			
	27	Humble Seafood Co	/	1,162 70				
	27	Humble Seafood Co	/		339 71		168 41	
	27	Bill Brown (crew share)	/		98 76			
	27	Joe Green (crew share)	/		98 76			
		Totals		3,789 10	3,479 61 [C]	92 90	577 48	6 00

Receipts and Expenses

Bait and Ice		Truck/Auto Expenses		Insurance		Repairs		Crew Shares		Interest		Other		Personal	
						300	00								
9	04														
														200	00
176	40														
								107	83						
								107	83						
												PRINCIPAL		200	00
										75	00	175	00		
														200	00
199	65														
								110	44	[F]					
								110	44						
				241	75										
		21	03												
														200	00
171	30														
								98	76						
								98	76						
556	39	21	03	241	75	300	00	634	06	75	00	175	00	800	00

[C]

[4]—— Annual Summary for

Month	Monthly Cash Receipts	Galley Supplies	Fuel	Moorage	Bait & Ice
January	37,899.10	924.90	5,577.48	600.00	556.39
February	44,154.43	1,047.15	4,812.20	600.00	441.26
March	42,477.32	604.43	2,208.87	600.00	389.70
April	52,047.71	1,510.03	6,214.49	600.00	411.79
May	63,041.16	1,470.09	5,006.65	600.00	360.97
June	61,227.47	1,596.60	5,623.31	600.00	341.26
July	67,141.12	1,808.82	6,103.37	600.00	489.70
August	58,772.87	1,763.35	6,432.77	600.00	402.30
September	50,377.32	1,685.50	5,207.77	600.00	355.75
October	47,288.61	1,529.90	5,906.61	600.00	390.47
November	36,955.80	1,644.63	5,388.44	600.00	339.60
December	41,555.94	1,556.60	5,197.73	600.00	271.31
Totals	602,877.85	17,130.00	63,671.49	7,200.00	4,750.50

[5]—— DEPRECIATION

Description	Date Placed in Service	Total Cost	New or Used	Investment Credit Amount	Investment Credit Year Claimed / Used	Section 179 Amount	Salvage Value
Fishing Boat (Chatham)	1/30/80	50,000	N	5,000	80 / 80	—	10,000
Pots & Traps	7/2/86	7,000	N	N/A		1,000	N/A
Gill Net	7/3/86	1,500	N	N/A		—	N/A
Fishing Boat (Salem)	1/3/87	38,000	N	N/A		—	N/A
Pots & Traps	1/89	6,000	N	N/A		2,000	N/A
Truck (USA Rover)	8/90	10,000	N	N/A		2,128	N/A

Monthly Expenses

Truck/Auto Expenses	Insurance	Repairs	Crew Shares	Taxes/Other	Interest
2103	24175	30000	63406		7500
1832	24175	25000	81425		7223
2150	24175	15000	83682		7018
1604	24175	60000	45033		7004
3407	24175	40000	120685	STATE License	6984
4321	24175	30000	117784	FEE 3500	7313
5248	30675	57400	122737		6210
4860	30675	24000	107455		6540
9250	30675	32500	41454		6430
3968	30675	35000	81541		6245
2870	30675	49400	59226		6003
2537	30675	54000	74723		5425
50500	324100	459300	1044461	3500	80000

[E]

RECORD

Depreciation Information					19 89			19 90	
Basis	Life or Recovery Period	Method	Depreciation Prior Years	ACRS %	Basis	Depreciation This Year	ACRS %	Basis	Depreciation This Year
40,000	16YRS	SL	22,500	—	17,500	2,500	—	Sold 1/5/90	—
6,000	5YRS	ACRS	3,480	21.7%	6,000	1,260	21.7%	6,000	1,200
1,500	5YRS	ACRS	870	21%	1,500	315	21%	1,500	315
38,000	7YRS	200 DB MACRS	14,736	17.49%	38,000	6,646	12.49%	38,000	4,746
4,000	7YRS	200 DB MACRS	—	14.27%	4,000	572	24.49%	4,000	980
5,872	5YRS	200 DB MACRS	—						2,128
TOTAL DEPRECIATION FOR 1990									9,429

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172

1990

Attachment Sequence No. 67

Name(s) shown on return: Frank Carter

Identifying number: 111-00-1111

Business or activity to which this form relates: Fishing

Part I **Election To Expense Certain Tangible Property (Section 179)** (Note: *If you have any "Listed Property," also complete Part V.*)

1 Maximum dollar limitation (see instructions)	1	$10,000
2 Total cost of section 179 property placed in service during the tax year (see instructions)	2	8,000
3 Threshold cost of section 179 property before reduction in limitation	3	$200,000
4 Reduction in limitation—Subtract line 3 from line 2, but do not enter less than -0-	4	—
5 Dollar limitation for tax year—Subtract line 4 from line 1, but do not enter less than -0-	5	10,000

(a) Description of property	(b) Cost	(c) Elected cost
6		
7 Listed property—Enter amount from line 26	7	2,128

8 Total elected cost of section 179 property—Add amounts in column (c), lines 6 and 7	8	2,128
9 Tentative deduction—Enter the lesser of line 5 or line 8	9	2,128
10 Carryover of disallowed deduction from 1989 (see instructions)	10	—
11 Taxable income limitation—Enter the lesser of taxable income or line 5 (see instructions)	11	10,000
12 Section 179 expense deduction—Add lines 9 and 10, but do not enter more than line 11	12	2,128
13 Carryover of disallowed deduction to 1991—Add lines 9 and 10, less line 12 ▶	13	—

Note: *Do not use Part II or Part III below for automobiles, certain other vehicles, cellular telephones, computers, or property used for entertainment, recreation, or amusement (listed property). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1990 Tax Year (Do Not Include Listed Property)**

(a) Classification of property	(b) Mo. and yr. placed in service	(c) Basis for depreciation (Business use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
14 General Depreciation System (GDS) (see instructions):						
a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
h Nonresidential real property			31.5 yrs.	MM	S/L	
			31.5 yrs.	MM	S/L	
15 Alternative Depreciation System (ADS) (see instructions):						
a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Proof as of 10/16/90

Part III **Other Depreciation (Do Not Include Listed Property)**

16 GDS and ADS deductions for assets placed in service in tax years beginning before 1990 (see instructions)	16	5,726
17 Property subject to section 168(f)(1) election (see instructions)	17	—
18 ACRS and other depreciation (see instructions)	18	1,575

Part IV **Summary**

19 Listed property—Enter amount from line 25	19	
20 Total—Add deductions on line 12, lines 14 and 15 in column (g), and lines 16 through 19. Enter here and on the appropriate lines of your return. (Partnerships and S corporations—see instructions)	20	9,429
21 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs (see instructions)	21	

Part V **Listed Property.—Automobiles, Certain Other Vehicles, Cellular Telephones, Computers, and Property Used for Entertainment, Recreation, or Amusement**

If you are using the standard mileage rate or deducting vehicle lease expense, complete columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A.—Depreciation (**Caution:** *See instructions for limitations for automobiles.*)

22a Do you have evidence to support the business use claimed? ✓ Yes ___ No 22b If "Yes," is the evidence written? ✓ Yes ___ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business use percentage	(d) Cost or other basis	(e) Basis for depreciation (business use only)	(f) Recovery period	(g) Method / Convention	(h) Depreciation deduction	(i) Elected section 179 cost
23 *Property used more than 50% in a trade or business*								
1990 USA Rover	8-90	80 %	10,000	8,000	5	200 DB/HY		2,128
		%						
		%						
24 *Property used 50% or less in a trade or business*								
		%				S L -		
		%				S L -		
		%				S L -		
25 Add amounts in column (h). Enter the total here and on line 19, page 1							25	
26 Add amounts in column (i). Enter the total here and on line 7, page 1							26	2,128

Proof as of 10/16/90

Section B.—Information Regarding Use of Vehicles—*If you deduct expenses for vehicles:*

- *Always complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.*
- *If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.*

	(a) Vehicle 1	(b) Vehicle 2	(c) Vehicle 3	(d) Vehicle 4	(e) Vehicle 5	(f) Vehicle 6
27 Total business miles driven during the year (DO NOT include commuting miles)	4,480					
28 Total commuting miles driven during the year	—					
29 Total other personal (noncommuting) miles driven	1,120					
30 Total miles driven during the year—Add lines 27 through 29	5,600					

	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
31 Was the vehicle available for personal use during off-duty hours?	✓											
32 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
33 Is another vehicle available for personal use?	✓											

Section C.—Questions for Employers Who Provide Vehicles for Use by Their Employees

(Answer these questions to determine if you meet an exception to completing Section B. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.)*

	Yes	No
34 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
35 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
36 Do you treat all use of vehicles by employees as personal use?		
37 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
38 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)?		

Note: *If your answer to 34, 35, 36, 37, or 38 is "Yes," you need not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
39 Amortization of costs that begins during your 1990 tax year:					
40 Amortization of costs that began before 1990				40	
41 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return				41	

[6]—— Crew Share – Compensation Record

Name	Address	Social Security No.	Phone
Bill Brown	1116 Ocean Drive Hometown, Oregon 97331	444-00-5555	370-1121

Self-Employed Crewmember

Date	Member's Share	Member's Percentage of Catch or Proceeds	Operator's Percentage of Catch or Proceeds	Estimated Value of Shares	Type of Catch	Total Weight
1/7 [F]	107.83	12	76			
1/14	110.44	12	76			
1/21	98.76	12	76			
Monthly Totals.....	317.03					
2/4	118.33	12	76			
2/11	122.60	12	76			
2/18	166.20	12	76			
Monthly Totals.....	407.13					
3/4	121.40	12	76			
3/11	140.90	12	76			
3/18	122.74	12	76			
	[G]					
Yearly Totals.....	5,495.81	12	76			

Employee

☐ Full-Time ☐ Part-Time — Number of Exemptions

Pay Period Ending	Total Wages	Deduction: Social Security	Deduction: Federal Income Tax	Deduction: State Income Tax	Deduction: Other	Net Pay
Quarterly Totals...						

Notes

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	1 Rents	OMB No. 1545-0115	Miscellaneous Income
Frank Carter 215 Seagull Drive Hometown, Oregon 97331	$	1990	
	2 Royalties $	Statement for Recipients of	
	3 Prizes, awards, etc. $		

PAYER'S Federal identification number	RECIPIENT'S identification number	4 Federal income tax withheld	5 Fishing boat proceeds	Copy B For Recipient
10-9999999	444-00-5555	$	$ 5495.81	

RECIPIENT'S name	6 Medical and health care payments	7 Nonemployee compensation	
Bill Brown	$	$	
Street address: 1116 Ocean Drive	8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
City, state, and ZIP code: Hometown, Oregon 97331	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional)	12 State/Payer's state number		

Form 1099-MISC — Department of the Treasury - Internal Revenue Service

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business
(Sole Proprietorship)

Partnerships, Joint Ventures, Etc., Must File Form 1065.

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

1990

Attachment Sequence No. 09

Name of proprietor: Frank Carter

Social security number (SSN): 111 00 1111

A Principal business or profession, including product or service (see Instructions): Fishing

B Enter principal business code (from page 2) ▶ 2246

C Business name and address (include suite or room no.) ▶ 215 Seagull Drive, Hometown, OR 97331

D Employer ID number (Not SSN): 109999999

E Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

F Method(s) used to value closing inventory: (1) ☐ Cost (2) ☐ Lower of cost or market (3) ☐ Other (attach explanation) (4) ☑ Does not apply (if checked, go to line H)

		Yes	No
G	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? (If "Yes," attach explanation.)		
H	Are you deducting expenses for business use of your home? (If "Yes," see Instructions for limitations.)		✓
I	Did you "materially participate" in the operation of this business during 1990? (If "No," see Instructions for limitations on losses.)	✓	
J	If this is the first Schedule C filed for this business, check here ▶ ☐		

Part I Income

1	Gross receipts or sales. **Caution:** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see the Instructions and check here ▶ ☐	1	[D] 60,288
2	Returns and allowances	2	
3	Subtract line 2 from line 1. Enter the result here	3	60,288
4	Cost of goods sold (from line 38 on page 2)	4	
5	Subtract line 4 from line 3 and enter the **gross profit** here	5	60,288
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see Instructions)	6	
7	Add lines 5 and 6. This is your **gross income** ▶	7	60,288

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Part II Expenses

8	Advertising	8		21	Repairs and maintenance	21	[E] 4,593
9	Bad debts from sales or services (see Instructions)	9		22	Supplies (not included in Part III)	22	6,464
10	Car and truck expenses (attach Form 4562)	10	404	23	Taxes and licenses	23	35
11	Commissions and fees	11		24	Travel, meals, and entertainment:		
12	Depletion	12		a	Travel	24a	
13	Depreciation and section 179 expense deduction (not included in Part III) (see Instructions)	13	9,429	b	Meals and entertainment		
14	Employee benefit programs (other than on line 19)	14		c	Enter 20% of line 24b subject to limitations (see Instructions)		
15	Insurance (other than health)	15	3,291	d	Subtract line 24c from line 24b	24d	
16	Interest:			25	Utilities	25	
a	Mortgage (paid to banks, etc.)	16a		26	Wages (less jobs credit)	26	10,992
b	Other	16b	800	27a	Other expenses (list type and amount): Fuel 6,367		
17	Legal and professional services	17					
18	Office expense	18					
19	Pension and profit-sharing plans	19					
20	Rent or lease (see Instructions):						
a	Vehicles, machinery, and equip.	20a					
b	Other business property	20b	72	27b	Total other expenses	27b	6,367
28	Add amounts in columns for lines 8 through 27b. These are your **total expenses** ▶					28	42,447
29	**Net profit or (loss).** Subtract line 28 from line 7. If a profit, enter here and on Form 1040, line 12. Also enter the net profit on Schedule SE, line 2 (statutory employees, see Instructions). If a loss, you MUST go on to line 30 (fiduciaries, see Instructions)					29	17,841

30 If you have a loss, you MUST check the box that describes your investment in this activity (see Instructions).
If you checked 30a, enter the loss on Form 1040, line 12, and Schedule SE, line 2 (statutory employees, see Instructions). If you checked 30b, you MUST attach **Form 6198.**

30a ☐ All investment is at risk.
30b ☐ Some investment is not at risk.

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also, Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F)

▶ Attach to your tax return. ▶ See separate Instructions.

OMB No. 1545-0184

1990

Attachment Sequence No. 27

Name(s) shown on return: Frank Carter

Identifying number: 111-00-1111

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty and Theft—Property Held More Than 1 Year**

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1990 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 1

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2							

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3 Gain, if any, from Form 4684, Section B, line 21		
4 Section 1231 gain from installment sales from Form 6252, line 22 or 30		
5 Gain, if any, from line 32, from other than casualty and theft		15,000
6 Add lines 2 through 5 in columns (g) and (h)	( )	15,000
7 Combine columns (g) and (h) of line 6. Enter gain or (loss) here, and on the appropriate line as follows:		15,000

Partnerships.—Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations.—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others.—If line 7 is zero or a loss, enter the amount on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years (see Instructions)	
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):	

S corporations.—Enter this amount (if greater than zero) on Form 1120S, Schedule D, line 7, and skip lines 11 and 12 below.

All others.—If line 9 is zero, enter the amount from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the amount from line 9 as a long-term capital gain on Schedule D.

Part II **Ordinary Gains and Losses**

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7		
12 Gain, if any, from line 7, or amount from line 8 if applicable		25,000
13 Gain, if any, from line 31		
14 Net gain or (loss) from Form 4684, Section B, lines 13 and 20a		
15 Ordinary gain from installment sales from Form 6252, line 21 or 29		
16 Recapture of section 179 deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see Instructions)		
17 Add lines 10 through 16 in columns (g) and (h)	( )	25,000
18 Combine columns (g) and (h) of line 17. Enter gain or (loss) here, and on the appropriate line as follows:		25,000

a For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.

b For individual returns:

(1) If the loss on line 11 includes a loss from Form 4684, Section B, Part II, column (b)(ii), enter that part of the loss here and on line 21 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)". See Instructions

(2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 15 — 25,000

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 Description of section 1245, 1250, 1252, 1254, and 1255 property:	Date acquired (mo., day, yr.)	Date sold (mo., day, yr.)
A Fishing Boat	1-3-80	1-5-90
B		
C		
D		

Relate lines 19A through 19D to these columns ▶	Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	65,000			
21 Cost or other basis plus expense of sale	50,000			
22 Depreciation (or depletion) allowed or allowable	25,000			
23 Adjusted basis. Subtract line 22 from line 21	25,000			
24 Total gain. Subtract line 23 from line 20	40,000			
25 If section 1245 property:				
a Depreciation allowed or allowable from line 22	25,000			
b Enter the **smaller** of line 24 or 25a	25,000			
26 If section 1250 property: If straight line depreciation was used, enter zero on line 26g unless you are a corporation subject to section 291.				
a Additional depreciation after 12/31/75 (see Instructions)				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see Instructions)				
c Subtract line 26a from line 24. If line 24 is not more than line 26a, skip lines 26d and 26e				
d Additional depreciation after 12/31/69 and before 1/1/76				
e Applicable percentage multiplied by the **smaller** of line 26c or 26d (see Instructions)				
f Section 291 amount (corporations only)				
g Add lines 26b, 26e, and 26f				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if you are a partnership.				
a Soil, water, and land clearing expenses				
b Line 27a multiplied by applicable percentage (see Instructions)				
c Enter the **smaller** of line 24 or 27b				
28 If section 1254 property:				
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see Instructions)				
b Enter the **smaller** of line 24 or 28a				
29 If section 1255 property:				
a Applicable percentage of payments excluded from income under section 126 (see Instructions)				
b Enter the **smaller** of line 24 or 29a				

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Summary of Part III Gains (Complete property columns A through D, through line 29b before going to line 30.)

30 Total gains for all properties. Add columns A through D, line 24	40,000
31 Add columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13. (See the Instructions for Part IV if this is an installment sale.)	25,000
32 Subtract line 31 from line 30. Enter the portion from casualty and theft on Form 4684, Section B, line 15. Enter the portion from other than casualty and theft on Form 4797, line 5	15,000

Part IV Election Not to Use the Installment Method (Complete this part only if you elect out of the installment method and report a note or other obligation at less than full face value.)

33 Check here if you elect out of the installment method . . . . . ▶ ☐

34 Enter the face amount of the note or other obligation . . . . . ▶ $

35 Enter the percentage of valuation of the note or other obligation . . . . . ▶ %

Part V Recapture Amounts Under Sections 179 and 280F When Business Use Drops to 50% or Less (See Instructions for Part V.)

	(a) Section 179	(b) Section 280F
36 Section 179 expense deduction or section 280F recovery deductions		
37 Depreciation or recovery deductions (see Instructions)		
38 Recapture amount. Subtract line 37 from line 36. (See Instructions for where to report.)		

IRS Publications

Listed below are the numbers and titles of selected IRS tax publications. The list includes all the publications referred to in the chapters of this book, as well as others that might be of interest to you. A full list can be found in Publication 910, *Guide to Free Tax Services.*

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15 ..... Employer's Tax Guide (Circular E)
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80 ..... Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

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Index

Accounting methods.....8
Accounting periods.....7
Adjusted basis of assets.....6
Advance payment of earned income credit.....26
Appeal rights.....30
Backup withholding.....25
Barter income.....8
Basis of business assets:
  Fair market value.....16
Books and records.....5
Bribes.....12
Business assets.....5
Business assets:
  Adjusted basis.....6
  Constructing basis.....6
  Cost basis.....6
  Depreciation.....12
  Other basis.....6
  Sales and exchanges.....16
Business expenses.....8
Business start-up costs.....11
Capital assets.....17
Capital Construction Fund.....27
Capital expenses.....9
Car expenses.....10
Carryover, capital loss.....22
Casualties.....19
Changing accounting method.....8
Changing tax year.....8
Crew members, self-employed.....24
Deposits, income and social security taxes.....26
Depreciation.....12
  Basis for figuring.....13
  Gain on depreciable property.....18
  Modified accelerated cost recovery system (MACRS).....14
  Section 179 deduction.....13
  Unclaimed.....13
Earned income credit notification.....26
Employee, defined.....24
Employment taxes.....24
Estimated tax.....3
Examination of returns.....30
Excise taxes:
  Claiming a credit.....29
  Claiming a refund.....29
  Commercial fishing.....27
  Credit includible in gross income.....29
  Diesel-powered highway vehicles.....28
  Diesel fuel.....28
  How to claim a credit or refund.....29
  Nontaxable purposes.....28
  Off-highway use.....27
  Refund includible in gross income.....29
Expenses paid in advance.....8
Federal unemployment tax (FUTA).....26
Filing requirements.....3
Filled-in records and returns:
  Annual summary for Schedule C entries.....31
  Crew-share—compensation record.....32
  Daily cash receipts and expenses diary.....31
  Depreciation record.....31
  Monthly summary of receipts and expenses.....31
  Schedule C (Form 1040).....32
Filled in records and returns:
  Fishhouse ticket.....31
Fishing gross income.....3, 8
Gains and losses:
  Capital asset.....17
  Form 4684.....22
  Form 4797.....22
  Long-term.....21
  Noncapital asset.....18
  Ordinary or capital.....17
  Reporting.....21
  Schedule D.....21
  Short-term.....21
Gross income.....8
Gross income:
  Fishing.....3, 8
  Total.....3
Identification number.....3
Improvements.....9
Income tax:
  Forms.....4
  Withholding.....25
Inherited property.....7
Insurance expense.....11
Interest expense.....11
Involuntary conversions.....19
  Postponement of gain.....20
  Replacement period.....20
  Replacement property.....20
Involuntary exchange:
  Basis of property.....6
Kickbacks.....12
Listed property.....12
Losses:
  At-risk limit.....12
  Capital assets.....17
  Casualties.....19
  Figuring.....16
  Net operating (NOL).....11
  Theft.....19
Meals and lodging.....9
Modified accelerated cost recovery system (MACRS).....14
  Alternate MACRS method.....15
  Declining balance method.....14
  Excluded property.....15
  Property classes.....14
  Straight-line method.....15
Net earnings defined, self-employment.....23
Noncapital assets.....18
Nondeductible expenses.....12
Nontaxable exchanges.....6, 16
Not-for-profit fishing.....9
Penalties:
  Employment taxes.....26
Property received for services.....6
Records:
  Or recordkeeping.....5, 11
Rent expense.....11
Repairs.....9
Replacement period.....20
Replacement property.....20
Replacements.....9
Retirement plans.....10
Returns:
  Due dates.....3
  Examination.....30
  Fishermen due dates.....4
  Identification number.....3
  Information.....4
  Sample.....32
  When and where to file.....4
  Who must file.....3
Salaries and wages.....9
Sales and exchanges.....16
  Nontaxable exchanges.....16
  Related parties.....17
Sample record system.....31
Section 179 deduction.....13
Self-employed, certain crew members.....24
Self-employment tax.....22
Social security taxes, withholding.....25
Standard mileage rate.....10
Tax dates to remember.....2
Taxes.....9
  Sales.....9
Tax shelter limitations.....12
Transfer of property between spouses.....7, 17
Travel expenses.....10
Using your home in your business.....11
Withholding:
  Backup.....25
  Deposits of taxes.....26
  Income tax.....25
  Social security taxes.....25

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